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Calendar No. 1187

95TH CONGRESS
2d Session

SENATE

REPORT
No. 95-1263

REVENUE ACT OF 1978

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

ON

H.R. 13511

[Together with cost estimates of the Congressional Budget Office]

OCTOBER 1, 1978 (legislative day, SEPTEMBER 28, 1978)
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95TH CONGRESS
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REPORT
No. 95–1263

REVENUE ACT OF 1978

OCTOBER 1 (legislative day, SEPTEMBER 28), 1978.—Ordered to be printed
Filed under authority of the order of the Senate of September 28, 1978

Mr. LONG, from the Committee on Finance,
submitted the following

REPORT

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

[To accompany H.R. 13511]

[Together with cost estimates of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (H.R. 13511) to amend the Internal Revenue Code of 1954 to reduce income taxes, and for other purposes, having considered same, reports favorably with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

The Revenue Act of 1978 (H.R. 13511) is designed to provide tax reductions to stimulate consumer and investment spending in order to increase economic growth. In addition, it contains many tax changes designed to improve the equity of the tax system and to simplify it.

Overview

Principal provisions

The principal provisions of the Revenue Act of 1978, as amended by the Finance Committee, are the following:

- A permanent tax reduction for individuals, amounting to $14.5 billion for 1979.
- A permanent tax rate reduction for corporations, amounting to $5.1 billion in 1979.
- A major expansion of the earned income tax credit for the working poor, which will amount to $1.7 billion in 1979. In addition, the credit is simplified and will be reflected in an employee's paychecks, rather than paid out in one lump sum as a tax refund.
- An increase in the zero bracket amount and the corresponding floor under itemized deductions (which replaced the standard deduction) from $2,200 to $2,300 for single persons, from $2,200 to $3,000 for single heads of households, and from $3,200 to $3,400 for married couples.
- An increase in the personal exemption from $750 to $1,000 to replace the expiring general tax credit, and an additional personal exemption for certain disabled individuals under age 65.
- A doubling of the tax credit for political contributions.
- An increase in the tax credit for the elderly.
- Repeal of the itemized deduction for nonbusiness State and local gasoline taxes.
- An increase from 50 percent to 70 percent in the proportion of long-term capital gains excluded from taxable income.
- An additional, partial exclusion for capital gains from the sale of a principal residence.
- Replacement of the existing add-on minimum tax for individuals by an alternative tax, which individuals will pay only if it exceeds their regular income tax. The alternative tax will have rates up to 25 percent.
- A capital gains tax rate reduction for corporations.
- Deferral of carryover of basis at death until the end of 1979.
- Accelerated depreciation for equipment through liberalization and simplification of the Asset Depreciation Range (ADR) system.
- Denial of business deductions for use of certain entertainment facilities, such as yachts, country clubs and hunting lodges.
- An expansion of the WIN-welfare tax credit to encourage both business and non-business employers to hire welfare applicants and recipients.

- A targeted jobs tax credit, to replace the existing general jobs tax credit, designed to encourage people to hire needy youths, disabled SSI beneficiaries, and other categories of people who frequently have difficulty finding jobs.
- A permanent 10-percent investment tax credit.
- A permanent extension of the employee stock ownership provisions in the investment tax credit (TRASOP) and technical revisions to them.
- A tax credit designed to encourage people in low tax brackets, and institutions not subject to tax, to buy tax-exempt State and local government bonds.
- Revised subchapter S rules.
- Additional funding of $0.4 billion (a total of $2.9 billion) for social services under Title XX of the Social Security Act.
- Fiscal relief for welfare expenditures of $0.4 billion for fiscal year 1979.

Overall revenue effect

The bill will provide new tax cuts of $23 billion in calendar year 1979 and $28 billion in 1980. The budget effect in fiscal year 1979, including both the new tax cuts and the extensions of expiring tax cuts, is a revenue reduction of $20.6 billion.

Of the new tax cuts for 1979, $16 billion represents individual income tax cuts, $4 billion represents business tax cuts and $3 billion represents reductions in capital gains taxes for individuals and corporations.[1]

Individual income taxes

There are three principal individual income tax cuts, which will affect virtually all taxpayers. The bill increases the personal exemption from $750 to $1,000. This increase in the exemption will replace the temporary general tax credit, which equals the greater of $35 for each exemption or 2 percent of the first $9,000 of income. The bill replaces the existing tax rate schedule, which contains 25 brackets, with a new schedule with only 15 wider brackets and lower rates. Also, it increases the zero bracket amount and the corresponding floor under itemized deductions, which replaced the old standard deduction, from $2,200 to $2,300 for single persons, from $3,200 to $3,400 for married couples, and from $2,200 to $3,000 for single heads of households. Together, these three provisions will reduce individual income taxes by $14.5 billion in 1979.

The bill significantly expands the earned income tax credit for the working poor. Currently, the credit is 10 percent of the first $4,000 of earnings and is phased out as income rises between $4,000 and $8,000. Under the bill, the credit would be 12 percent of the first $5,000 of earnings (an increase in the maximum credit from $400 to $600), and

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[1] The revenue loss from the capital gains tax cut for individuals, except for the special provision for residences, is reduced by one-third ($1 billion in calendar year 1979, $1 billion in 1980 and $0.1 billion in fiscal year 1979) to take account of the offsetting revenue gain expected from additional sales of appreciated assets resulting from the capital gains tax reduction. The Committee believes that this feedback revenue effect will be at least this large and probably much larger.

the phaseout range would be increased to between $6,000 and $11,000. The credit will also be simplified so that it will be easier to compute. Finally, instead of being paid out as one lump sum at the close of the taxable year, the credit will be reflected in employees' paychecks, making it a more effective work incentive and providing the tax relief more evenly throughout the year. The credit will be treated as earned income for purposes of determining eligibility for, and benefits under, certain Federal assistance programs. The tax cut and additional outlays from the increased earned income credit amount to $1.7 billion for 1979.

The bill provides an additional personal exemption for permanently and totally disabled individuals who are not receiving Federal payments under disability programs. The additional exemption will be $500 for 1979 and 1980 and $1,000 thereafter. The bill also expands the existing tax credit for the elderly, increasing the amount of income eligible for that credit from $2,500 to $3,000 for single persons and from $3,750 to $4,500 for married couples. In addition, the income level above which the elderly credit phases out is increased from $7,500 to $15,000 for single persons and from $10,000 to $17,500 for married couples.

The bill repeals the deduction for nonbusiness State and local gasoline taxes in order to simplify the tax return and to take account of the fact that these taxes really represent user charges for the use of highways.

In addition, the bill doubles the present tax credit for political contributions in order to encourage wider political participation.

To try to reduce the growth of Federal spending, the bill includes an income tax surcharge on individuals and corporations equal to the amount by which the growth in Federal spending, adjusted for inflation, exceeds 2 percent. If such a surcharge is enacted, it will be a powerful force in restraining excessive government spending.

Business taxes

The bill provides a sizable reduction in the corporate income tax rate. The top corporate tax rate is reduced from 48 percent to 46 percent, and a system of graduated tax rates is established for small businesses. In place of the existing rates of 20 percent on the first $25,000 of taxable income, 22 percent on taxable income between $25,000 and $50,000, and 48 percent on taxable income in excess of $50,000, the new rate schedule will be 17 percent on the first $25,000 of income, 20 percent on income between $25,000 and $50,000, 30 percent on income between $50,000 and $75,000, 40 percent on income between $75,000 and $100,000 and 46 percent on income above $100,000. This tax reduction, amounting to $5 billion in 1979, is designed to increase business investment and encourage the formation and expansion of small businesses. About $1 billion of the tax cut will be received by businesses with incomes below $100,000.

A second major incentive for business investment is a major liberalization of accelerated depreciation. The asset depreciation range (ADR) system is expanded by allowing businesses to shorten useful lives of equipment by 30 percent, instead of the 20-percent variance allowed under existing law. Also, the ADR system is simplified to encourage more businesses to elect it.

The bill makes permanent the existing 10-percent investment tax credit, as well as the $100,000 limitation on the amount of used property eligible for the credit and the extra investment credit for contributions to Tax Reduction Act employee stock ownership plans (TRASOP's). The availability of the credit is also liberalized by increasing the tax liability limitation to 90 percent on a phased-in basis. The credit is amended to clarify its application to single purpose farm structures and for cooperatives, and it is extended to breeding and work horses and to certain lessors of railroad equipment. The full investment credit is extended to pollution control facilities for which the taxpayer has elected 5-year amortization. (These facilities now receive only one-half the normal investment credit.) There are also a number of technical amendments to the provision giving an extra investment credit to employers who contribute to employee stock ownership plans. Finally, the bill extends for one year the carryover period for investment tax credits expiring in 1977.

In place of the existing general jobs tax credit, which expires at the end of this year, the bill increases the rate of the existing WIN and welfare recipient tax credit and provides a new targeted jobs credit to encourage businesses to hire needy youths and others who often have difficulty finding jobs even when the economy is prosperous. For employers who hire welfare recipients and WIN registrants, the WIN-welfare tax credit will be 75 percent of the first $6,000 of wages for the first year of employment, 65 percent for the second year and 55 percent for the third year. Businesses will not receive a deduction for wages offset by the credit. The wage base will be increased to $7,000 in 1981 and future years. In addition, there will be a 50-percent credit for the first year for welfare recipients (limited to two per employer) who are hired outside of a trade or business. The categories of people eligible for the new targeted jobs credit include needy youths, needy Vietnam-era veterans, disabled SSI recipients, convicted felons and recipients of general assistance. The credit will be 50 percent of the first $6,000 of wages for the first year of employment, 33⅓ percent for the second year and 25 percent for the third year. The expanded earned income credit and WIN and welfare credits should greatly increase the employment of people who are now on welfare, and the new targeted jobs credit should help alleviate the serious unemployment problems of the covered groups.

The bill denies businesses a deduction for entertainment facilities, including yachts, country clubs and hunting lodges because generally these facilities are used mostly for personal reasons.

Capital gains and minimum and maximum tax provisions

The bill contains a major reduction in the income tax on capital gains. This is designed to encourage greater investment in new and risky enterprises and to increase the mobility of capital by encouraging taxpayers to sell appreciated assets. The committee believes that these beneficial economic effects of the capital gains tax reduction will greatly reduce the revenue loss from the capital gains tax cut and possibly even result in a revenue gain to the Treasury.

Specifically, the bill increases the percentage of long-term capital gains excluded from taxable income from 50 percent to 70 percent,

effective for sales after October 31, 1978. To ensure that this tax cut does not result in high-income persons paying very low effective rates of tax, the bill imposes an alternative minimum tax with rates up to 25 percent. Individuals will pay this minimum tax only if it exceeds their tax computed the regular way. This new alternative minimum tax will replace the existing add-on minimum tax for individuals and will be more effective in achieving the objectives of the minimum tax.

The bill also removes capital gains from the tax preferences which reduce the amount of earned income eligible for the 50-percent maximum tax.

The 50-percent maximum tax on personal service income is also liberalized by expanding the definition of earned income for businesses in which both capital and labor are used to produce income.

The bill also reduces the corporate capital gains tax rate from 30 percent to 28 percent.

The application of the provision for carryover of basis at death, enacted in 1976, is deferred through the end of 1979. This deferral will give Congress time to study this extremely complicated question.

The bill provides a significant additional exclusion for gains from the sale of a taxpayer's principal residence. For residences sold for $50,000 or less, all of the gain will be excluded from income. For residences sold for more than $50,000, the fraction of the gain excluded from income will be $50,000 divided by the selling price. The rest of the gain will be taxed under the rules applicable to capital gains generally, so that only 30 percent of the rest of the gain will be taxed. Also, gains from the sale of principal residences will be excluded from the minimum tax. The committee believes that this approach achieves the twin goals of providing major tax relief for gains on principal residences, while assuring that high-income people pay at least some minimum amount of tax on their income. Finally, the bill liberalizes the current rollover provision for gains on principal residences for people who must move in connection with employment.

The bill limits the minimum tax on intangible drilling costs on oil and gas wells to the amount by which these costs exceed income from oil and gas production.

Tax-exempt State and local government bonds

To encourage persons in lower income tax brackets, pension funds and other tax-exempt institutions to buy tax-exempt State and local government securities, the bill allows taxpayers to elect to receive a 67-percent credit instead of exempting the interest on their State and local government bonds. (The credit will be refundable for tax-exempt institutions.) Bondholders electing the credit will have to include both their interest income and the credit itself in their taxable income. This credit will give an electing taxpayer the same benefit as tax exemption for the interest provides for a taxpayer in the 40-percent tax bracket. The committee believes that this optional credit will reduce interest costs to State and local governments and make the tax exemption for their bonds a more efficient way of assisting them. All bonds eligible for tax exemption under the Internal Revenue Code, except industrial development bonds, will be eligible for this credit.

The bill also makes a number of other changes in the provisions relating to tax-exempt bonds. The $1 million limit on small issues of industrial development bonds is raised to $2 million, and the $5 million limit on the amount of capital expenditures for the project is raised to $12 million. The bill permits advance refundings for industrial development bonds used to finance certain public projects. The bill also includes a transitional rule to exempt certain bonds issued in connection with advanced refunding of certain exempt industrial devolopment bonds. It exempts interest from industrial development bonds for water projects and certain other public facilities. The bill also provides judicial review for private letter rulings relating to the tax exempt status of proposed bond issues and permits certain issuers of arbitrage bonds to distribute arbitrage profits to public charities.

Small business provisions

In addition to the substantially lower corporate tax rates for the first $100,000 of taxable income, the bill contains several provisions relating to small businesses. The bill liberalizes the rules for eligibility for subchapter S corporations, which allow a corporation to elect to be taxed in a manner generally similar to a partnership. Also, the bill simplifies and liberalizes the provision which permits ordinary loss treatment (i.e., full deductibility) for certain venture capital investments.

Employee compensation

The bill allows employees and independent contractors performing services for a State or local government to defer annually an amount equal to the lesser of $7,500 or 33⅓ percent of their currently includible compensation. In addition, compensation deferred under unfunded deferred compensation plans maintained by taxable employers and tax-exempt organizations would be subject to the principles of law applying before February 1, 1978.

Under the bill, participants in nondiscriminatory "cafeteria" plans would not have taxable income to the extent they elect to receive nontaxable benefits. ("Cafeteria plans" are employee fringe benefit plans permitting participants to choose among fringe benefits they want purchased with employer contributions.)

Also, the bill provides rules under which participants in "cash or deferred" profit sharing plans can defer tax on amounts paid into the plan.

The bill allows limited tax deductions to participants in a private qualified pension plan for employee contributions to a plan or employer contributions to an IRA on behalf of an employee on a basis that does not favor officers, shareholders, or higher-paid workers.

The bill provides tax changes designed to remove the adverse tax consequences of a life insurance company's selling an annuity contract to a public employee retirement plan.

Under the bill, self-insured medical and accident reimbursement plans would be required not to discriminate in favor of officers, shareholders or highly compensated employees in order for participants to obtain favorable tax treatment. In addition, within certain limitations, the value of educational assistance provided by employers would

be excluded from an employee's income for purposes of the Federal income tax.

Other tax provisions

The bill exempts from corporate income tax State-chartered corporations set up to provide General Stock Ownership Corporations (GSOP's) for the residents of any State. Under these plans, the shareholders of the corporation (i.e., all residents of the State) would be taxed currently on their pro rata share of the corporation's taxable income in a manner similar to shareholders of subchapter S corporations under current law.

The bill provides a deficiency dividend procedure for small business investment companies similar to that now provided for mutual funds.

Under the bill, contributions in aid of construction to regulated gas and electric utilities would be treated as nontaxable contributions to capital, the same treatment now given to water and sewer utilities.

Current law regarding employer reporting of tip income is extended.

The 4-percent excise tax on investment income of private foundations is reduced to 2 percent. The existing excise tax credit for State taxes paid on coin operated slot machines is increased from 80 percent to 95 percent for 1979 and 1980, and the Federal tax is repealed entirely thereafter.

The bill extends for one year the current exclusion for amounts received by participants in the Armed Forces health professions scholarship program and the Public Health Service/National Health Service Corps scholarship program, pending a study of these issues.

Also, the bill extends through 1982 the moratorium on taxation of certain student loan cancellations.

The bill extends the effective date of the rules adopted in the Tax Reform Act of 1976 relating to trafficking in net operating loss carryovers.

The bill postpones for 3 years the 5-year amortization of expenditures for rehabilitation of low-income housing.

The bill provides relief for taxpayers involved in controversies with the IRS about employment tax status reclassifications of workers whom the taxpayers had not considered to be their employees.

It extends the exception to the source rules for interest on deposits in foreign branches of U.S. commercial banks to interest on deposits with foreign branches of U.S. savings and loan associations.

The bill makes some technical changes to the rules for real estate investment trusts.

The bill extends the family corporation exception to the rules requiring the accrual method of accounting and capitalization of preproductive period expenses by farm corporations to certain two- and three-family corporations. In addition, there are changes in accounting rules for sod farms, florists, nurseries and certain other farmers.

The estate tax rules are changed to give a surviving spouse the equivalent of partial ownership of a farm or small business owned by the deceased spouse.

There is an exemption from the investment credit recapture rules for the bankrupt railroads which transferred property to ConRail and changes in the net operating loss trafficking rules as they apply to ConRail.

The bill provides for Treasury studies of the tax treatment of foreign owners of U.S. real estate, of the appropriate depreciation or amortization of equipment required by occupational health and safety (OSHA) or mine safety (MSHA) regulations, and of ways to simplify income tax returns for individuals.

The bill also expands the volunteer income tax assistance program of the Internal Revenue Service by authorizing the IRS to enter into training and technical assistance agreements with nonprofit agencies to prepare volunteers to provide tax counseling to elderly individuals.

Welfare and social services provisions

Fiscal relief for State and local welfare costs

The Congress authorized $187 million as fiscal relief to States and localities for fiscal year 1978 as part of the Social Security Amendments of 1977. The committee bill would make available an estimated $400 million in additional Federal funding of welfare costs as a means of providing fiscal relief to State and local governments in fiscal year 1979. This one-time provision would be payable as soon as possible after March 31, 1979. The payment would be based on an allocation of $500 million on the basis of a two-part formula. Half of the fiscal relief funds would be allocated to each State in proportion to its share of total expenditures under the program of aid to families with dependent children (AFDC) for December 1976, and half would be distributed under the general revenue sharing formula. To receive its full share of the payment, however, each State would have to demonstrate that it had reduced its payment error rate (overpayments and payments to ineligibles) in the AFDC program to 4 percent or less as of the October 1978–March 1979 quality control sampling period. States which had not reached a 4-percent-or-less payment error rate by that period could still receive some payment depending on the degree of their progress toward that rate since a base period. At State option, the base period could be either the July–December 1974 or January–June 1975 quality control sampling period. If, for example, a State had a 12-percent error rate in the base period and had reduced that error rate to 8 percent as of October 1978–March 1979, the State would receive a payment equal to one-half of its full fiscal relief allocation since it had progressed one-half of the way toward the 4-percent goal. In any case, a State would receive at least 90 percent of its full allocation if its AFDC error rate for October 1978–March 1979 is 5 percent or less. A State would receive at least 75 percent of its full allocation if its error rate in that period is 6 percent or less.

In some States, local units of government are responsible for meeting part of the costs of the AFDC program. The fiscal relief payments to those States under this provision would have to be passed through to local governments. However, States would not be required to pass through an amount in excess of 90 percent of the amount of the welfare costs for which the local government was otherwise responsible.

Increase in ceiling

There has been a $2.5 billion ceiling on Federal social services spending under the Social Security Act since 1972. The only additional funding which has been made available to the States for social services

since 1972 has been earmarked for child care services. The 94th and 95th Congresses authorized $200 million for child care for each of fiscal years 1977 and 1978.

The committee bill would continue the $200 million authorization for child care services for one additional year. As in the previous fiscal years, the child care funding would be available on a 100 percent Federal funding basis. The committee bill would also provide an additional $200 million for spending by the States under the regular title XX program, thus providing for an overall spending level of $2.9 billion for fiscal year 1979. All funds would continue to be allocated on the basis of State population.

Increased State flexibility.—The committee bill also contains two provisions to give States increased flexibility in planning and operating their social services programs. Present law requires each State to prepare a social services plan on an annual basis. The committee bill would allow States to develop plans for 1, 2, or 3 years. In addition, the committee bill would give States the option of using the county fiscal year for their services program year, as well as either the Federal or State fiscal year, as is provided in present law.

AFDC management information system

The committee bill would provide incentives for the States to develop and operate computerized management information systems for their aid to families with dependent children (AFDC) programs.

Under the committee bill, the rate of Federal matching for the costs of computerized management information systems would be increased from the present rate of 50 percent to 90 percent for the costs of developing and implementing the systems and to 75 percent for the costs of operating them.

The Department of Health, Education, and Welfare would be required, on a continuing basis, to provide technical assistance to the States and would have to approve the State system as a condition of Federal matching. (Continuing review of the State systems would also be required.) To qualify for HEW approval, the system would have to have at least the following characteristics:

1. Ability to provide data concerning all AFDC eligibility factors;
2. Capacity for verification of factors with other agencies;
3. Capability for notifying child support, food stamp, social services, and medicaid programs of changes in AFDC eligibility or benefit amount; and
4. Security against unauthorized access to or use of the data in the system.

In approving systems, the Department would have to assure sufficient compatibility among the systems of different jurisdictions to permit periodic screening to determine whether an individual was drawing benefits from more than one jurisdiction and for determination of eligibility and payment pursuant to requirements imposed by other provisions of the Social Security Act. (The increased matching would be applicable to existing systems if they meet the criteria for approval of new systems.)

Work incentive program

Under the work incentive (WIN) program, recipients of AFDC are required to register for manpower training and employment services,

unless they are excluded under provisions of the law. Individuals who participate in the WIN program also receive supportive services, including child care, if these services are necessary to enable them to participate. Under the committee bill, AFDC recipients who are not excluded from registration by law would be required, as a condition of continuing eligibility for AFDC, to register for, and participate in, employment search activities, as a part of the WIN program. These employment search activities are intended to be directed by professional manpower staff and supported by necessary transportation services, and would be arranged to the maximum extent possible while children are in school or when other family demands are at a low level.

The bill would require the provision of such social and supportive services as are necessary to enable the individual actively to engage in activities related to finding employment and, for a period thereafter, as are necessary and reasonable to enable him to retain employment. In addition, it would allow States to match the Federal share for social and supportive services with in-kind goods and services, instead of being required to make only a cash contribution.

The bill would provide for locating manpower and supportive services together to the maximum extent feasible, eliminate the requirement for a 60-day counseling period before assistance can be terminated, and authorize the Secretaries of Labor and HEW to establish the period of time during which an individual will continue to be ineligible for assistance in the case of a refusal without good cause to participate in a WIN program. The bill would also clarify the treatment of earned income derived from public service employment.

Incentive to report earnings

Quality control reviews show that a large percentage of the payment errors made in the AFDC program are related to earned income and the failure of the recipient to report the correct amount of any changes in earnings. A few States require that all income be reported on a monthly basis, as a condition of eligibility. Most States do not do this. When they learn that a recipient had unreported earned income in prior months, they must under present law give him the benefit of all the earned income disregards provided by law in calculating the amount of the overpayment. Thus if a recipient is negligent in reporting his earnings even over a long period of time, there is no penalty involved.

The committee bill would provide an incentive to report income by specifying that there would be no disregard of any earned income which the recipient has not reported to the State agency.

Federal matching for child support duties performed by court personnel

Present law requires that State child support plans provide for entering into cooperative arrangements with appropriate court and law enforcement officials to assist the child support agency in administering the program. The law specifically provides for entering into financial arrangements with courts and officials. However, HEW regulations do not allow States to claim Federal matching for certain activities now being performed under these arrangements. The committee bill would authorize matching for these administrative

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expenses of the IV–D program. Matching would cover compensation of judges and other support and administrative personnel of the courts who perform IV–D functions, but only for those functions specifically identifiable as IV–D functions. Matching would be paid by the State agency directly to the courts if the State so provided. Current levels of spending in the State for these newly matched activities would have to be maintained. No matching would be available for expenditures incurred before January 1, 1979.

Treatment of territories under social security assistance programs

Under present law, 50 percent Federal matching is available for assistance to the aged, blind, and disabled, and to families with dependent children in Puerto Rico, Guam, and the Virgin Islands, subject to overall dollar limitations. The committee bill would increase the Federal matching percentage from 50 percent to 75 percent while tripling the dollar limitations. This will permit the territories to double the size of their assistance programs with no increase in non-Federal matching. The amounts for each territory are shown in the table below.

FEDERAL FUNDS FOR ASSISTANCE PROGRAMS

	Present law (50 percent Federal matching)	Committee bill (75 percent Federal matching)
Puerto Rico	$24,000,000	$72,000,000
Virgin Islands	800,000	2,400,000
Guam	1,100,000	3,300,000

II. GENERAL REASONS FOR THE BILL

The committee believes that a major tax reduction for both individuals and business is needed to maintain the vigor of the current economic recovery and to compensate for tax increases which will occur in 1979. Tax reductions for individuals are needed to offset the increase in social security taxes which was enacted in 1977 and which will take effect next year, as well as the automatic tax increase that will result from the inflation expected between 1978 and 1979. Tax reductions for business and capital gains tax reductions are needed to stimulate investment, which has been inadequate for the last five years.

In addition, it is appropriation to review the tax system periodically to see whether it is having the appropriate impact on the economy and whether tax burdens are in accordance with taxpayers' ability to pay. This bill is part of that periodic review. Furthermore, the committee is concerned about the complexity of the tax system, which is demoralizing to taxpayers. The specific tax changes in the bill are designed to make the tax system more equitable, simpler and more conducive to economic efficiency and growth.

In deciding on the appropriate level and distribution of individual income tax reductions, the committee took into account the expected tax increases in 1979 from inflation and from the legislated social security tax increase. While it is impossible to give every individual taxpayer a tax cut large enough to compensate for these tax increases, the committee has structured the individual income tax cuts so that every income class receives a tax cut large enough to compensate for the inflation and social security tax increases in 1979 over 1978.

The committee concluded that the appropriate size of the tax cut for individuals is $16 billion. This amount of tax reduction for individuals strikes the appropriate balance between the need to keep consumer spending at a level high enough to maintain the vigor of the economic recovery and the conflicting need to bring the Federal budget into balance by the early 1980's. A larger individual tax cut would be fiscally irresponsible because it would risk overheating the economy and aggravating an inflation rate which is already far too high and because it would eliminate all possibility of a balanced Federal budget in the foreseeable future.

The committee also believes that the individual income tax should be as simple as possible, and several of the individual income tax changes in the bill help achieve this goal. These changes include the substitution of a $1,000 personal exemption for the complicated general tax credit, the repeal of the deduction for nonbusiness State and local gasoline taxes, and the postponement of carryover of basis at death.

Some have argued that it would be preferable to index the individual income tax for inflation. This could be achieved by automatically increasing all fixed dollar amounts in the tax system by the rate of

inflation. The committee disagrees with this approach. Indexing would make it very difficult to conduct a responsible fiscal policy, particularly in view of the already large Federal deficits. Indexing would also reduce the nation's political will to combat inflation. The committee believes that discretionary tax cuts every year or two are a more appropriate way to offset the automatic inflation-induced tax increase than automatic indexing.

The committee is particularly concerned with the plight of the working poor. The House bill did not provide enough tax relief for lower-income people to compensate for the ravages of inflation, particularly higher food, energy and housing costs. Also, the committee believes it essential to provide strong incentives for people to work rather than be on welfare. For these reasons, the bill contains a major increase in, and restructuring of, the earned income tax credit.

Business taxes

A substantial business tax cut is necessary to stimulate business investment in plant and equipment, which is the key to improving productivity, reducing the rate of inflation, and improving our balance of trade. While consumer spending is substantially above its peak prior to the 1973–75 recession, it is only recently that investment spending has attained its pre-recession peak. Furthermore, an increasing portion of investment is needed to meet federally mandated requirements under environmental, occupational health and safety and other laws. Because of these regulations and because the labor force is growing rapidly, to achieve the same rate of growth of productivity, the rate of growth of investment must be higher than in the past.

Testimony before the committee strongly suggested that the most effective way to increase business investment was a reduction in the corporate tax rate. The 48-percent top corporate tax rate has not been reduced since 1964. Thus, the committee agreed with the House that a corporate rate reduction to 46 percent was needed to stimulate business investment. In addition, to provide help to small businesses, there is a 5-step graduated rate structure to replace the 3-step rate structure under existing law.

However, the committee did not believe that this corporate rate cut would provide enough investment stimulus in view of the very serious investment shortage. Thus, the committee agreed to provide additional accelerated depreciation through a liberalization of the Asset Depreciation Range (ADR) system. This tax cut would be directly tied to additional investment in equipment.

A second major concern of the committee with respect to business taxes was the need to provide incentives to encourage businesses to hire the hard-core unemployed—people who have trouble finding jobs even when the economy is prosperous. In 1977, Congress enacted a temporary jobs tax credit to increase hiring. Since then, the unemployment rate has fallen from above 7 percent to below 6 percent, and the problem now is not so much general unemployment but rather structural unemployment. Therefore, the committee agreed with the House that the general jobs tax credit should be allowed to expire at the end of the year and should be replaced by an expanded WIN-welfare tax credit and a new targeted jobs tax credit directed toward

categories of people with chronic unemployment problems. The targeted jobs credit and the expanded WIN-welfare tax credit in the committee's bill will provide a strong incentive for businesses to hire the hard-core unemployed and should make a major contribution to reducing unemployment in the years ahead.

Capital gains

The committee believes that the current capital gains tax is counterproductive in the sense that it discourages investment and discourages sales of appreciated assets to such an extent that it doe not provide as much revenue as would result from lower capital gains rates. In addition, the current rules regarding capital gains, which involve a regular tax, a minimum tax, an alternative tax and a maximum tax, are unnecessarily complex. Furthermore, the existing capital gains tax is inquitable to the extent that gains are taxed which only represent inflationary increases in value. As a result, the bill includes a major restructuring of the tax on capital gains and the current minimum and maximum taxes.

The main feature of this restructuring is an increase from 50 percent to 70 percent in the amount of capital gains excluded from taxable income. The committee believes that this tax cut will encourage additional sales of appreciated assets and that the tax revenue from these unlocked capital gains will be sufficient to offset much of the revenue loss from the tax cut and possibly lead to an actual revenue increase. In addition, the improved mobility of capital and the increased after-tax profitability of potential investments will lead to a substantial increase in investment activity. Six former Secretaries of the Treasury have told the committee that they believe that lower capital gains taxes will raise revenues, rather than lower them, and studies by private economists support this judgment.

Although the decrease in capital gains taxes is intended to stimulate investment activity, the committee does not approve of situations in which individuals take advantage of the law to escape income taxation entirely. The existing add-on minimum tax is not an adequate response to this problem; it provides too high a tax on people paying substantial amounts of regular income tax, and it provides too little tax on taxpayers paying very ltitle regular income tax. Thus, the committee's bill eliminates the existing add-on minimum tax and replaces it with an alternative minimum tax. Taxpayers will pay this alternative minimum tax, the top rate of which will be 25 percent as opposed to 15 percent for the existing minimum tax, only if it exceeds their regular income tax.

In addition, there are special problems for people with gains on principal residences. The bill includes a partial exclusion for these gains, over and above the general 70-percent exclusion.

III. REVENUE EFFECTS OF THE BILL

Table 1 summarizes the revenue effect of the new tax reduction in H.R. 13511, as reported by the Senate Finance Committee, in calendar years 1979 through 1983. It shows the net tax reducation for individuals, businesses, for taxpayers with capital gains, and other provisions. The bill provides a net tax reduction of $22,912 million in 1979, $27,773 million in 1980, and $42,353 million in 1983.

Table 2 summarizes the net revenue effect of the bill on a fiscal year basis. The new tax cuts in the bill will reduce fiscal year 1979 receipts by $11,660 million, fiscal 1980 receipts by $25,586 million, and fiscal 1983 receipts by $40,003 million. When the fiscal year effects of the extensions of expiring tax cuts are included, the revenue effect in fiscal year 1979 is $20,554 million.

Table 3 shows the revenue effect in calendar years 1979 through 1983 of the various separate provisions of H.R. 13511. Part A shows the revenue effect of new tax reductions and revisions for individuals, businesses, capital gains changes, and minimum and maximum tax provisions. Part B shows the revenue effect of extending or making permanent existing temporary income tax reduction provisions.

Table 4 has the same format in both Parts A and B as Table 3, but shows the fiscal year revenue effects.

Table 5 shows the revenue effect by expanded income class (at 1978 income levels) of the provisions of H.R. 13511 which affect individuals, with the exception of the exclusion for capital gains on the sale of principal residences. This table also shows the distribution of the individual tax reductions as a percent of the total reduction and also as a percent of the present law tax liability. 70.1 million returns would receive a reduction averaging $239 and 1.2 million returns would experience a tax increase averaging $200. The increases result from a combination of the repeal of the general tax credit and the deduction for State and local gasoline taxes.

The capital gains tax reductions in the committee's bill will have beneficial effects on the economy which will increase revenues enough to offset much of the tax cut, and possibly to cause a net increase in revenues. These "feedback revenue effects" result from the increased number of sales of appreciated assets resulting from lower capital gains taxes and the additional investment which will occur. As a conservative estimate of these feedback effects, tables 1 through 4 assumed that they equal one-third of the tax cut from increasing the 50-percent exclusion to 70 percent and from changing the minimum tax to an alternative tax. (Table 5 does not include any feedback effects because it is difficult to attribute these to particular income classes; therefore, they may not present an entirely accurate picture of the distributional impacts of the bill.)

Table 6 shows the revenue effect of the tax changes in the bill relating to capital gains and the minimum tax. These are static estimates,

which assume no change in economic behavior in response to the tax change. As noted above, the committee believes that the capital gains tax cuts in the bill will have beneficial economic effects which will serve to increase federal revenues by an amount large enough to offset much, and possibly all, of the tax cut.

Table 7 shows the tax reduction from the partial exclusion for capital gains from the sale of principal residences at 1978 income levels by expanded income class.

Table 8 shows the individual income tax burden by family size at various assumed levels of income and deductions under present law and under the bill. This table includes only the changes in the personal exemption, zero bracket amount, rate schedules, and repeal of the general tax credit.

Table 1.—Summary of Revenue Effect of H.R. 13511, as Reported by the Committee, Calendar Years 1979-83

[In millions of dollars]

Major Category	Calendar year liability				
	1979	1980	1981	1982	1983
Part A.—Tax Reductions and Revisions					
Individual Reduction	−16,030	−18,345	−21,303	−24,524	−28,354
Business Reduction	−4,073	−6,318	−8,530	−8,982	−10,193
Capital Gains Reduction	−2,677	−2,956	−3,147	−3,363	−3,575
Individual reduction	−2,560	−2,821	−2,999	−3,200	−3,395
Business reduction	−117	−135	−148	−163	−177
Minimum and Maximum Tax Provisions	−132	−154	−177	−202	−231
Total, Part A	**−22,912**	**−27,773**	**−33,157**	**−37,071**	**−42,353**
Part B.—Temporary Tax Reduction Extensions	**−15,977**	**−16,725**	**−22,659**	**−24,907**	**−26,701**
GRAND TOTAL, REDUCTIONS, REVISIONS, AND EXTENSIONS	**−38,889**	**−44,498**	**−55,816**	**−61,978**	**−69,054**

Table 2.—Summary of Revenue Effect of H.R. 13511, as Reported by the Committee, Fiscal Years 1979–83

[In millions of dollars]

Major Category	Fiscal year receipts				
	1979	1980	1981	1982	1983
Part A.—Tax Reductions and Revisions					
Individual Reduction	−8, 965	−17, 782	−20, 210	−23, 364	−26, 975
Business Reduction	−2, 243	−4, 984	−7, 213	−8, 845	−9, 451
Capital Gains Reduction	−374	−2, 685	−2, 963	−3, 155	−3, 370
Individual reduction	−321	−2, 560	−2, 822	−3, 000	−3, 209
Business reduction	−53	−125	−141	−155	−170
Minimum and Maximum Tax Provisions	−78	−135	−158	−181	−207
Total, Tax Reductions and Revisions	**−11, 660**	**−25, 586**	**−30, 544**	**−35, 545**	**−40, 003**
Part B.—Temporary Tax Reductions Extensions	**−8, 894**	**−16, 480**	**−19, 517**	**−23, 774**	**−25, 885**
GRAND TOTAL, TAX REDUCTIONS, REVISIONS, AND EXTENSIONS	**−20, 554**	**−42, 066**	**−50, 061**	**−59, 319**	**−65, 888**

Table 3.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Calendar Years 1979–83

Part A.—Tax Reductions and Revisions

Provisions	Calendar year liability				
	1979	1980	1981	1982	1983
Individual tax reductions and revisions					
1. Bracket widening, rate cuts, and increased zero bracket amount	−13,239	−15,608	−18,436	−21,815	−25,855
2. Repeal general tax credit	10,397	10,985	11,618	12,302	13,039
$1,000 personal exemption	−11,681	−12,382	−13,125	−13,913	−14,747
Additional exemption for disabled	−242	−254	−505	−532	−559
3. Repeal gasoline tax deduction	1,151	1,358	1,602	1,890	2,231
4. Increase the political contribution credit	−16	−26	−16	−16	−16
5. Increase the elderly credit	−278	−278	−278	−278	−278
6. Simplify the earned income credit	−17	−16	−16	−15	−14
Increase the earned income credit	−1,707	−1,639	−1,573	−1,510	−1,450
7. Pension plan provisions:					
Additional contributions to pension plans	−320	−392	−466	−513	−564
IRA pension plans	−15	−25	−35	−45	−55
8. Deferred compensation provisions	(2)	(2)	(2)	(2)	(2)
9. Uniformed Services scholarship exclusion	(2)	(2)	(2)	(2)	(2)
10. Cancellation of student loans	(2)	(2)	(2)	(2)	----------
11. Employer educational assistance	−26	−29	−32	−36	−40
12. Reporting for tips[5]	(5)	(5)	(5)	(5)	(5)
13. Revised estate tax for jointly-owned farms and businesses	−37	−39	−41	−43	−46
Total, individual	**−16,030**	**−18,345**	**−21,303**	**−24,524**	**−28,354**

Business tax reductions and revisions					
1. Cut rate on income over $100,000 from 48 to 46 percent, and tax income below $100,000 as follows: 0 to $25,000 at 17 percent; $25,000 to $50,000 at 20 percent; $50,000 to $75,000 at 30 percent; and $75,000 to $100,000 at 40 percent	−5,069	−5,551	−6,078	−6,655	−7,288
2. Investment credit provisions:					
Increase investment tax credit limitation to 90 percent (phased in over 4 years)	−287	−629	−1,169	−826	−728
Investment credit for pollution control facilities	−14	−49	−108	−187	−228
Investment credit for certain farm structures	−22	−22	−23	−25	−27
Investment credit for farm cooperatives	−33	−34	−36	−38	−40
Investment credit for breeding and draft horses	- 15	−17	−18	−20	−22
Extend for one year the carryover period for unused investment credits expiring at the end 1977	(2)	(2)	(2)	(2)	(2)
Modify investment credit limitation for lessors of railroad cars	−8	−2	2	2	2
Investment credit recapture on property transfers to ConRail					
3. Repeal general jobs credit	2,458	2,458	2,458	2,458	2,458
Targeted jobs credit	−330	−547	−698	−89	−89
WIN credit	−161	−260	−340	−394	−455

See footnotes at end of table.

Table 3.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Calendar Years 1979–83—Continued

Part A.—Tax Reductions and Revisions

Provisions	Calendar year liability				
	1979	1980	1981	1982	1983
***Business tax reductions and revisions*—Con.**					
4. Industrial development bonds:					
Increase limitation on capital expenditures	−3	−13	−24	−34	−45
Bonds for water projects	−4	−20	−38	−57	−79
Bonds for certain public facilities	(2)	(2)	(2)	(2)	(2)
Advance refundings	−7	−8	−8	−9	−9
5. Bondholder taxable option	−38	−186	−334	−477	−607
6. Subchapter S corporations	(1)	(1)	(1)	(1)	(1)
7. Small business corporation stock	(2)	(2)	(2)	(2)	(2)
8. Accrual accounting for farming corporations	(2)	(2)	(2)	(2)	(2)
9. ADR range increased to 30 percent	−513	−1,415	−2,100	−2,626	−3,040
10. Modification in minimum tax treatment in connection with TRASOP credits	(2)	(2)	(2)	(2)	(2)
11. GSOC investment credit	(3)	(3)	(3)	(3)	(3)
12. Denial of deduction for expenditures on certain entertainment facilities	113	121	132	145	158
13. Deficiency dividends for regulated investment companies	(1)	(1)	(1)	(1)	(1)
14. REIT provision	(2)	(2)	(2)	(2)	(2)

15. Contributions in aid of construction [4]	−96	−98	−101	−103	−107
16. Treatment of certain liabillties of controlled corporations		(2)	(2)	(2)	(2)
17. Self-insured medical plans	(2)	(2)	(2)	(2)	(2)
18. NCL trafficking postponement	(2)	(2)	(2)	(2)	(2)
19. Independent contractor status	(2)	(2)	(2)	(2)	(2)
20. Puerto Rico S. & L. associations	(2)	(2)	(2)	(2)	(2)
21. Reduce excise tax to 2 percent of foundation investment income	−40	−40	−40	−40	−40
22. Excise tax on gaming machines phased out	−4	−6	−7	−7	−7
Total, business	**−4, 073**	**−6, 318**	**−8, 530**	**−8, 982**	**−10, 193**
Capital gains reductions and revisions					
Individual:					
1. Repeal alternative tax	133	143	154	166	178
2. 70% capital gains deduction	−3, 394	−3, 648	−3, 922	−4, 216	−4, 532
3. Exclude gains from sale of a principal residence	−295	−325	−357	−393	−432
4. Sale of personal residence within 18 months	−3	−3	−3	−3	−3
5. Postponement of carryover basis	−93	−162	−133	−110	−94
Corporate:					
Reduce alternative tax rate on capital gains	−117	−135	−148	−163	−177
Tax increase from induced capital gains realizations	1, 092	1, 174	1, 262	1, 356	1, 485
Total capital gains	**−2, 677**	**−2, 956**	**−3, 147**	**−3, 363**	**−3, 575**

See footnotes at end of table.

Table 3.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Calendar Years 1979–83—Continued

Part A.—Tax Reductions and Revisions

Provisions	Calendar year liability				
	1979	1980	1981	1982	1983
Minimum and maximum tax provisions					
1. Repeal existing minimum tax	−1,566	−1,722	−1,894	−2,083	−2,292
2. Alternative minimum tax	1,603	1,763	1,939	2,133	−2,347
3. Intangible drilling costs in minimum tax	−61	−73	−84	−97	111
4. Maximum tax provisions	−108	−122	−138	−155	−175
Total, minimum and maximum tax	**−132**	**−154**	**−177**	**−202**	**−231**
Total, Tax Reductions and Revisions	**−22,912**	**−27,773**	**−33,157**	**−37,071**	**−42,353**

Part B.—Estimated Revenue Effect of Extending or Making Permanent Existing Temporary Income Tax Reduction Provisions, Calendar Years 1979–1983 [6]

Individual income taxes					
Per capita credit [1]	−6,449	−6,642	−6,842	−7,047	−7,258
Optional taxable income credit [1]	−3,949	−4,344	−4,778	−5,256	−5,782
Earned income credit	−1,061	−1,019	−978	−938	−900
Investment tax credit at 10-percent rate			−722	−773	−829
Amortization for low-income housing	([2])	−4	−9	−13	−16
Jobs tax credit [7]	−983	−983	−983	−983	−983
Total, individual income taxes	**−12,442**	**−12,992**	**−14,312**	**−15,010**	**−15,768**

See footnotes at end of table.

Table 3.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Calendar Years 1979–83—Continued

Part B.—Estimated Revenue Effect of Extending or Making Permanent Existing Temporary Income Tax Reduction Provisions, Calendar Years 1979–1983 [6]—Continued

[In millions of dollars]

Provisions	Calendar year liabilities				
	1979	1980	1981	1982	1983
Corporation income taxes					
Rate reductions	−2,060	−2,255	−2,470	−2,704	−2,961
Investment tax credit at 10-percent rate			−4,000	−5,201	−5,894
TRASOP investment credit at 1½-percent rate			−396	−508	−592
Amortization for low-income housing	(1)	−3	−6	−9	−11
Jobs tax credit [7]	−1,475	−1,475	−1,475	−1,475	−1,475
Total, corporation income taxes	**−3,535**	**−3,733**	**−8,347**	**−9,897**	**−10,933**
Total, Temporary Tax Reduction Extensions	**−15,977**	**−16,725**	**−22,659**	**−24,907**	**−26,701**
GRAND TOTAL, TAX REDUCTIONS, REVISIONS AND EXTENSIONS	**−38,889**	**−44,498**	**−55,816**	**−61,978**	**−69,054**

[1] Less than $1 million.
[2] Less than $5 million.
[3] The revenue cost of this provision is expected to be negligible during the next few years. However, the long run cost could be substantial.
[4] The estimates were derived assuming that the position taken by the IRS is the correct one. The figures do not allow for revenue effects of additional charges the utilities may make in order to get reimbursement for the additional taxes payable under IRS ruling.
[5] This provision has the effect of overturning Revenue Rulings 75–400 and 76–231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. This revenue is not being collected at the present time, therefore, no change in budget receipts is estimated.
[6] These items are not extended by H.R. 13511, but are allowed to expire after 1978 and are replaced by an increase in the personal exemption from $750 to $1,000.
[7] The expiring general jobs tax credit is not extended and an offsetting entry is shown in part A of this table.

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Table 4.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Fiscal Years 1979–83

Part A.—Tax Reductions and Revisions

Provisions	Fiscal year receipts				
	1979	1980	1981	1982	1983
Individual tax reductions and revisions					
1. Bracket widening, rate cuts, and increased zero bracket amount	−8,034	−14,694	−17,347	−20,515	−24,306
2. Repeal general tax credit	7,278	10,809	11,428	12,097	12,818
$1,000 personal exemption	−8,177	−12,171	−12,902	−13,677	−14,497
Additional exemption for disabled	−121	−248	−379	−519	−546
3. Repeal gasoline tax deduction	471	1,237	1,458	1,720	2,029
4. Increase the political contribution credit		−16	−26	−16	−16
5. Increase the elderly credit	−104	−278	−278	−278	−278
6. Simplify the earned income credit		−17	−16	−16	−15
Increase the earned income credit	−110	−1,969	−1,624	−1,558	−1,497
7. Pension plan provisions:					
Additional contributions to pension plans	−144	−352	−425	−487	−536
IRA pension plans	−6	−18	−29	−39	−49
8. Deferred compensation provisons	(2)	(2)	(2)	(2)	(2)
9. Uniformed services scholarship exclusion	(2)	(2)	(2)	(2)	(2)
10. Cancellation of student loans	(2)	(2)	(2)	(2)	(2)
11. Employer educational assistance	−18	−28	−31	−35	−39
12. Reporting for tips	(6)	(6)	(6)	(6)	(6)
13. Revised estate tax for jointly-owned farms and businesses	(1)	−37	−39	−41	−43
Total, individual	**−8,965**	**−17,782**	**−20,210**	**−23,364**	**−26,975**

Table 4.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Fiscal Years 1979–83—Continued

Part A.—Tax Reductions and Revisions

Provisions	Fiscal year receipts				
	1979	1980	1981	1982	1983
Business tax reductions and revisions					
1. Cut rate on income over $100,000 from 48 to 46 percent, and tax income below $100,000 as follows: 0 to $25,000 at 17 percent; $25,000 to $50,000 at 20 percent; $50,000 to $75,000 at 30 percent; and $75,000 to $100,000 at 40 percent	−2,281	−5,286	−5,788	−6,388	−6,940
2. Investment credit provisions:					
Increase investment tax credit limitation to 90 percent (phased in over 4 years)	−129	−441	−872	−1,015	−782
Investment credit for pollution control facilities	−10	−34	−85	−156	−211
Investment credit for certain farm structures	−53 [3]	−33	−22	−24	−26
Investment credit for farm cooperatives	−46 [3]	−33	−35	−37	−39
Investment credit for breeding and draft horses	−6	−16	−17	−19	−21

Extend for 1 year the carryover period for unused investment credits expiring at the end of 1977	(2)	(2)	(2)	(2)	(2)
Modify investment credit limitation for lessors of railroad cars	−4	−5	(1)	2	2
Investment credit recapture on property transfers to ConRail[3]	(2)				
3. Repeal general jobs credit	689	2,458	2,458	2,458	2,458
Targeted jobs credit	−120	−428	−568	−543	−82
WIN credit	−58	−223	−314	−370	−422
4. Industrial development bonds:					
Increase limitation on capital expenditures	(1)	−4	−17	−29	−39
Bonds for water projects	(1)	−6	−26	−49	−65
Bonds for certain public facilities	(2)	(2)	(2)	(2)	(2)
Advance refundings	(1)	−4	−9	−9	−9
5. Bondholder taxable option	(1)	−30	−174	−320	−467
6. Subchapter S corporations	(1)	(1)	(1)	(1)	(1)
7. Small business corporation stock	(2)	(2)	(2)	(2)	(2)
8. Accrual accounting for farming corporations	(2)	(2)	(2)	(2)	(2)
9. ADR range increased to 30 percent	−231	−919	−1,723	−2,337	−2,812
10. Modification in minimum tax treatment in connection with TRASOP credits	(2)	(2)	(2)	(2)	(2)
11. GSOC investment credit	(4)	(4)	(4)	(4)	(4)
12. Denial of deduction for expenditures on certain entertainment facilities	51	116	126	138	151
13. Deficiency dividends for regulated investment companies	(1)	(1)	(1)	(1)	(1)
14. REIT provision	(2)	(2)	(2)	(2)	(2)

See footnotes at end of table.

Table 4.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Fiscal Years 1979–83—Continued

Part A.—Tax Reductions and Revisions

Provisions	Fiscal year receipts				
	1979	1980	1981	1982	1983
***Business tax reductions and revisions*—Con.**					
15. Contributions in aid of construction [5]	(2)	−50	−100	−100	−100
16. Treatment of certain liabilities of controlled corporations	(2)	(2)	(2)	(2)	(2)
17. Self-insured medical plans		(2)	(2)	(2)	(2)
18. NOL postponement	(2)	(2)	(2)	(2)	(2)
19. Independent contractor status	(2)	(2)	(2)	(2)	(2)
20. Puerto Rico S. & L. associations	(2)	(2)	(2)	(2)	(2)
21. Reduce excise tax to 2 percent of foundation investment income	−40	−40	−40	−40	−40
22. Excise tax on gaming machines phased out	−5	−6	−7	−7	−7
Total, business	**−2, 243**	**−4, 984**	**−7, 213**	**−8, 845**	**−9, 451**
Capital gains reductions and revisions					
Individual:					
1. Repeal alternative tax	20	133	143	154	166
2. 70 percent capital gains deduction	−250	−3, 394	−3, 648	−3, 922	−4, 216
3. Exclude gains from sale of a principal residence	−138	−295	−325	−357	−393

4. Sale of personal residence within 18 months	−2	−3	−3	−3	−3
5. Postponement of carryover basis	−36	−93	−162	−133	−110
Corporate:					
Reduce alternative tax rate on capital gains	−53	−125	−141	−155	−170
Tax increase from induced capital gains realization	85	1,092	1,173	1,261	1,356
Total, capital gains	**−374**	**−2,685**	**−2,963**	**−3,155**	**−3,370**
Minimum and maximum tax provisions					
1. Repeal existing minimum tax		−1,566	−1,722	−1,894	−2,083
2. Alternative minimum tax		1,603	1,763	1,939	2,133
3. Intangible drilling costs in minimum tax	−51	−61	−73	−84	−97
4. Maximum tax provisions	−27	−111	−126	−142	−160
Total, minimum and maximum tax	**−78**	**−135**	**−158**	**−181**	**−207**
Total, Tax Reductions and Revisions	**−11,660**	**−25,586**	**−30,544**	**−35,545**	**−40,003**

[1] Less than $1 million.
[2] Less than $5 million.
[3] Includes liabilities of prior years.
[4] The revenue cost of the proposal is expected to be negligible during the next few years. However, the long run cost could be substantial.
[5] The estimates were derived assuming that the position taken by the IRS is the correct one. The figures do not allow for revenue effects of additional charges the utilities may make in order to get reimbursement for the additional taxes payable under IRS ruling.
[6] This provision has the effect of overturning Revenue Rulings 75–400 and 76–231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. This revenue is not being collected at the present time, therefore, no change in budget receipts is estimated.

Table 4.—Revenue Effect of H.R. 13511 by Provision, as Approved by the Senate Finance Committee, Fiscal Years 1979–83—Continued

Part B.—Estimated Revenue Effect of Extending or Making Permanent Existing Temporary Income Tax Reduction Provisions, Fiscal Years 1979–1983 [7]

[In millions of dollars]

Provisions	Fiscal year receipts				
	1979	1980	1981	1982	1983
Individual income taxes					
Per capita credit [1]	−4,514	−6,583	−6,780	−6,984	−7,194
Optional taxable income credit [1]	−2,764	−4,226	−4,648	−5,113	−5,624
Earned income credit		−1,061	−1,019	−978	−938
Investment tax credit at 10-percent rate			−271	−741	−794
Amortization for low-income housing	(8)	−2	−6	−11	−14
Jobs tax credit [9]	−125	−983	−983	−983	−983
Total, individual income taxes	**−7,403**	**−12,855**	**−13,707**	**−14,810**	**−15,547**

Corporation income taxes					
Rate reductions	−927	−2, 148	−2, 352	−2, 575	−2, 819
Investment tax credit at 10-percent rate			−1, 800	−4, 460	−5, 489
TRASOP investment credit at 1½ percent rate			−178	−446	−545
Amortization for low-income housing	(8)	−2	−5	−8	−10
Jobs tax credit [9]	−564	−1, 475	−1, 475	−1, 475	−1, 475
Total, corporation income taxes	**−1, 491**	**−3, 625**	**−5, 810**	**−8, 964**	**−10, 338**
Total, Temporary Tax Reduction Extensions	**−8, 894**	**−16, 480**	**−19, 517**	**−23, 774**	**−25, 885**
GRAND TOTAL, TAX REDUCTIONS, REVISIONS, AND EXTENSIONS	**−20, 554**	**−42, 066**	**−50, 061**	**−59, 319**	**−65, 888**

[7] These items are not extended by H.R. 13511, but are allowed to expire after 1978 and are replaced by an increase in the personal exemption from $750 to $1,000. The expiring general jobs tax credit is not included here, but it is shown in tables 3 and 4.

[8] Less than $500,000.

[9] The expiring general jobs tax credit is not extended and an offsetting entry is shown in part A of this table.

Table 5.—Distribution by Income Class of Individual Income Tax Changes Under H.R. 13511 [1]

[1978 income level]

Expanded income class (thousands)[2]	Returns with tax reduction (thousands)	Tax reduction (millions)	Returns with tax increase (thousands)	Tax increase (millions)	Net tax reduction (millions)	Percentage distribution of tax reduction	Tax cut as percent of present law tax
Below $5	7,274	$397	55	$1	$395	2.4	[3]68.3
$5 to $10	17,489	2,297	393	5	2,292	13.9	27.8
$10 to $15	13,359	1,457	540	8	1,449	8.8	8.5
$15 to $20	11,447	1,968	127	2	1,966	11.9	8.2
$20 to $30	12,924	3,685	17	4	3,681	22.3	8.2
$30 to $50	5,823	2,972	12	11	2,960	18.0	7.5
$50 to $100	1,422	1,860	7	11	1,849	11.2	7.7
$100 to $200	292	813	7	37	776	4.7	5.9
$200 and over	73	1,275	5	154	1,121	6.8	8.2
Total	**70,103**	**16,724**	**1,163**	**233**	**16,490**	**100.0**	**9.0**

[1] This table does not include the effect of the exclusion of gains from sales of principal residences. Also the tax increase or "feedback effect" from increased sales of capital assets is not included because of difficulty in estimating these effects by income class. Tables 3 and 4 show conservative estimates of the "feedback effect" for budget purposes.

[2] Expanded income equals adjusted gross income plus minimum tax preferences minus investment interest to the extent of investment income.

[3] Percentage of positive tax liability before offset by the refundable portion of the earned income credit.

Table 6.—Revenue Effect of Removing Capital Gains From Preferences, Repealing the Alternative Tax, and Establishing an Alternative Minimum Tax [1]

[1978 income level]

Expanded income class [3]	Returns with tax decrease (thousands)	Tax decrease (millions)	Returns with tax increase (thousands)	Tax increase (millions)	Net tax decrease (millions)	Percentage of total
Below $5	34	10	(2)	(2)	10	.3
$5 to $10	537	20	(2)	(2)	20	.6
$10 to $15	576	49	(2)	(2)	49	1.5
$15 to $20	690	106	(2)	(2)	106	3.2
$20 to $30	1,017	228	12	4	225	6.8
$30 to $50	915	464	20	15	449	13.6
$50 to $100	472	847	12	18	829	25.2
$100 to $200	136	533	8	44	489	14.9
$200 and over	45	1,269	5	157	1,112	33.8
Totals	**4,423**	**3,526**	**56**	**238**	**3,288**	**100.0**

[1] This table does not include the effect of the exclusion for gains from sales of
[2] Less than $500,000, 500 returns, or .05 percent.
[3] Expanded income equals adjusted gross income plus minimum tax preferences minus investment interest to the extent of investment income.

Table 7.—Tax Reduction From the Exclusion of Capital Gains From the Sale of a Principal Residence

[1978 income level]

Expanded income class (thousands)	Returns (thousands)	Tax reduction (millions)	Percentage of total
Below $5	30	1	.4
$5 to $10	46	4	1.5
$10 to $15	84	18	6.7
$15 to $20	75	25	9.3
$20 to $30	174	88	32.8
$30 to $50	112	104	38.8
$50 to $100	18	18	6.7
$100 to $200	4	7	2.6
$200 and over	1	3	1.1
Total	**544**	**268**	**100**

[1] Assuming a 70 percent capital gains exclusion.
[2] Expanded income equals adjusted gross income plus minimum tax preferences minus investment interest to the extent of investment income.

Note: Details will not add to totals because of rounding.

Table 8.—Federal Individual Income Tax Burden [1] for Hypothetical Taxpayers Under Certain Provisions [2] of H.R. 13511 for Single Person and Married Couple With No, One, Two, and Four Dependents (Assuming Deductible Personal Expenses of 23 percent of Income)

Income [3]	Tax liability														
	Single person			Married couple with no dependents			Married couple with one dependent			Married couple with two dependents			Married couple with four dependents		
	Under present law	Under the bill	Reduction	Under present law	Under the bill	Reduction	Under present law	Under the bill	Reduction	Under present law	Under the bill	Reduction	Under present law	Under the bill	Reduction
$3,000	0	0	0	0	0	0	−300	−360	60	−300	−360	60	−300	−360	60
$5,000	279	250	29	0	0	0	−300	−600	300	−300	−600	300	−300	−600	300
$6,000	449	422	27	115	84	31	−200	−600	400	−200	−600	400	−200	−600	400
$8,000	810	787	23	431	374	57	273	−136	409	120	−276	396	0	−360	360
$10,000	1, 199	1, 177	22	761	702	59	620	414	206	446	254	192	128	−36	164
$12,500	1, 631	1, 584	48	1, 186	1, 152	34	1, 059	972	87	917	792	125	562	454	108
$15,000	2, 126	2, 027	100	1, 651	1, 614	37	1, 486	1, 414	72	1, 330	1, 233	97	990	873	117
$17,500	2, 660	2, 526	135	2, 075	1, 999	76	1, 910	1, 799	111	1, 745	1, 599	146	1, 385	1, 220	165
$20,000	3, 232	3, 094	138	2, 555	2, 416	139	2, 368	2, 184	184	2, 180	1, 984	196	1, 808	1, 584	224
$25,000	4, 510	4, 343	167	3, 570	3, 358	212	3, 360	3, 100	260	3, 150	2, 860	290	2, 738	2, 380	358
$30,000	5, 590	5, 697	253	4, 712	4, 436	276	4, 472	4, 156	316	4, 232	3, 876	356	3, 778	3, 316	462
$35,000	7, 500	7, 199	302	6, 002	5, 664	338	5, 732	5, 344	388	5, 464	5, 024	440	4, 954	4, 394	560
$40,000	9, 233	8, 865	368	7, 427	7, 034	393	7, 135	6, 654	481	6, 848	6, 274	574	6, 278	5, 616	662
$50,000	12, 985	12, 538	447	10, 610	10, 195	415	10, 273	9, 765	508	9, 950	9, 335	615	9, 290	8, 475	815
$60,000	16, 835	16, 371	464	14, 230	13, 614	616	13, 856	13, 124	732	13, 496	12, 646	850	12, 746	11, 786	960
$70,000	20, 685	20, 221	464	18, 080	17, 387	693	17, 705	16, 897	808	17, 330	16, 407	923	16, 550	15, 427	1, 123
$80,000	24, 535	24, 071	464	21, 930	21, 190	740	21, 555	20, 690	865	21, 180	20, 190	990	20, 400	19, 200	1, 200
$90,000	28, 385	27, 921	464	25, 780	25, 040	740	25, 405	24, 540	865	25, 030	24, 040	990	24, 250	23, 040	1, 210
$100,000	32, 235	31, 771	464	29, 630	28, 890	740	29, 255	28, 390	865	28, 880	27, 890	990	28, 100	26, 890	1, 210

[1] Computed without reference to the tax tables.

[2] Includes only the repeal of general tax credit, increase in personal exemption, increase in zero bracket amount, rate reduction and widening of the tax brackets.

[3] Wage or salary and/or self-employment income.

NOTE—Negative tax liability results from the refundable earned income credit.

IV. EXPLANATION OF THE BILL

A. Individual Income Tax Reductions and Extensions

1. Overall individual income tax reductions

The committee concluded that an individual income tax reduction of approximately $16 billion rather than the $10 billion provided by the House bill is required to provide the necessary stimulus to the economy next year and to offset the scheduled increase in social security taxes and the automatic income tax increase caused by inflation. (The $16 billion refers to all individual reductions other than capital gains as shown in Table 3 in part III of the Report (Budget Effects of the Bill) for calendar year 1979. Table 1, below, shows the major individual reductions at $14 billion at 1978 income levels.)

The committee also wanted a larger portion of the tax reductions directed to low- and middle-income taxpayers because, although the committee agrees with the House that upper-income taxpayers have been hit hard both by recently legislated social security tax increases and by automatic inflation-induced income tax increases, low- and middle-income taxpayers have been more significantly affected by inflation and deserve tax relief.

Consequently, the committee while accepting the House bill's increase in the zero bracket amount (equivalent to an increase in the standard deduction under prior law) and the substitution of a larger personal exemption for the general tax credit, substantially expanded the earned income credit and modified the rate reduction in the House bill to provide more relief to low- and middle-income taxpayers.

The amount and distribution of the tax reduction resulting from the increase in the earned income credit, the increase in the zero bracket amount, the tax bracket and rate changes and the replacement of the general tax credit with a $250 increase in the personal exemption to $1,000, without regard to other provisions in the bill, are shown in Table 1 below (at 1978 income levels).

As Table 1 shows, in terms of percentage tax reduction and percentage distribution of tax reduction, the tax cut is more concentrated in the lower- and middle-income range than under the House bill. For example, 41 percent of the reduction goes to taxpayers with income under $20,000 compared to 28 percent in the House bill, and 68 percent goes to those below $30,000, compared to 58 percent in the House bill.

Table 1.—Tax Reduction from Expanded Earned Income Credit, New Rate Schedule, Increased Zero Bracket Amount and Substitution of a $1,000 Personal Exemption for the General Tax Credit, 1978 Income Levels

Expanded income class [2]	Tax decrease [1]			Returns with tax decrease (thousands)
	Amount (millions)	Percent of tax liability	Percentage distribution	
Below $5,000	$386	66.8 [3]	2.7	7,295
$5,000 to $10,000	2,249	27.2	15.8	17,830
$10,000 to $15,000	1,319	7.7	9.3	13,808
$15,000 to $20,000	1,899	7.9	13.4	11,558
$20,000 to $30,000	3,765	8.4	26.5	12,928
$30,000 to $50,000	2,850	7.3	20.1	5,832
$50,000 to $100,000	1,259	5.2	8.9	1,428
$100,000 to $200,000	368	2.8	2.6	299
$200,000 and over	120	.9	.8	78
Total	**14,213**	**7.7**	**100.0**	**71,056**

[1] For only those provisions listed above. The tax decrease does not, for example, include the tax cut from increasing the zero bracket amount from $2,300 to $3,000 for heads of households.

[2] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

[3] As a percent of positive liability before offset for the refundable portion of the earned income credit.

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

The tax reduction from the new rate schedule, the increased zero bracket amount, and the substitution of a $1,000 personal exemption for the general tax credit is shown in Table 2, i.e., Table 1 without the earned income credit increase.[1]

[1] The increase in the earned income credit results in a revenue reduction and an increase in outlays of $1,777 million at 1978 income levels. All of this reduction goes to the income classes under $15,000. For the under $5,000 class, the revenue reduction is $283 million, or 16 percent of the total; for the $5,000 to $10,000 class, it is $1,441 million, or 81 percent; and for the $10,000 to $15,000 class it is $53 million, or 3 percent.

Table 2.—Tax Reduction From New Rate Schedule, Increased Zero Bracket Amount and Substitution of a $1,000 Personal Exemption for the General Tax Credit, 1978 Income Levels

Expanded income class [1]	Tax decrease			Returns with tax decrease (thousands)
	Amount (millions)	Percent of tax liability	Percentage distribution	
Below $5,000	$104	18.0 [2]	.8	4,649
$5,000 to $10,000	807	9.8	6.5	16,254
$10,000 to $15,000	1,265	7.4	10.2	13,723
$15,000 to $20,000	1,899	7.9	15.3	11,558
$20,000 to $30,000	3,764	8.4	30.3	12,928
$30,000 to $50,000	2,850	7.3	22.9	5,832
$50,000 to $100,000	1,258	5.2	10.1	1,427
$100,000 to $200,000	368	2.8	3.0	299
$200,000 and over	120	0.9	1.0	78
Total	**12,436**	**6.8**	**100.0**	**66,748**

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to th ıextent of investment cinome.

[2] As a percent of positive tax liability before offset for the refundable portion of the earned income credit.

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

The impact of these changes on illustrative taxpayers at various income levels and of various family sizes is shown in Table 8 in Part III of the Report (*Budget Effects of the Bill*).

It should be noted that there are a few taxpayers—approximately 1.2 million or 2 percent of taxable returns—who will receive a tax increase mainly because of the combination of the repeal of the gasoline tax deduction, and the elimination of the general tax credit. These will generally be single persons or married couples with no children who itemize their deductions. There will be very few tax increases for nonitemizers.

Taxpayers with a tax decrease, on the other hand, will number 70 million.

One characteristic of the tax reductions in both the committee's bill and, to a lesser extent, in the House bill is that they reduce the tax penalty which people with relatively equal incomes must pay when they marry. The size of the marriage bonus or penalty for typical taxpayers under present law under the House bill and under the committee's bill is shown in Table 3. For example, for a couple with income of $30,000 in which the income is split evenly between the spouses, there is currently a tax increase upon marriage of $1,019. This would be reduced to $876 in the House bill, and the committee's bill would reduce it still further to $834. The committee believes that this reduction in the marriage penalty is a significant improvement in the equity of the tax system.

Table 3.—Marriage Bonus or Penalty Under Present Law and Under H.R. 13511 [1]

Income		Income Division Between Spouses					
		100–0	90–10	80–20	70–30	60–40	50–50
$5,000	Present Law	+278	+199	+118	+43	0	0
	House bill	+257	+176	+100	+28	0	0
	Committee bill	+252	+171	+95	+26	0	0
$10,000	Present Law	+460	+240	+49	−141	−194	−204
	House bill	+466	+269	+79	−105	−186	−204
	Committee bill	+466	+272	+82	−103	−188	−203
$20,000	Present Law	+1,102	+451	−32	−263	−423	−463
	House bill	+1,069	+452	−28	−235	−353	−393
	Committee bill	+1,097	+479	−6	−213	−331	−355
$30,000	Present Law	+1,934	+682	−50	−599	−920	−1,019
	House bill	+1,949	+749	+45	−453	−779	−876
	Committee bill	+2,020	+820	+110	−387	−737	−834
$50,000	Present Law	+3,710	+1,086	−674	−1,930	−2,640	−2,870
	House bill	+3,676	+1,180	−464	−1,673	−2,413	−2,626
	Committee bill	+3,333	+1,085	−490	−1,719	−2,456	−2,668

[1] The marriage bonus or penalty is the difference in the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person on his or her share of their combined income.

NOTE.—It is assumed that taxpayers do not itemize their deductions and have no dependents. Marriage bonuses are positive; marriage penalties are negative.

2. Widening of tax brackets, rate cuts in certain brackets and increase in zero bracket amount (sec. 101 of the bill and secs. 1 and 63 of the Code)

Present law

Under present law, individual income tax rates begin at 14 percent on taxable income in excess of $3,200 on a joint return and $2,200 on a single return. There is no tax on the first tax bracket, referred to as the "zero bracket amount." There is also a floor under itemized deductions equal to the zero bracket amount, so that itemizers can deduct only expenses in excess of that amount. This floor resulted from the conversion of the old standard deduction into a zero rate bracket and a floor under itemized deductions made by the Tax Reduction and Simplification Act of 1977 (P.L. 95–30).

Individual tax rates range up to 70 percent on taxable income in excess of $203,200 for joint returns ($102,200 for single returns), as shown in table 5, which shows the tax brackets and rates for joint returns under present law and under the bill. Under present law, there are 25 tax brackets.

Present law also provides different rate schedules for heads-of-households, married couples filing separately, and estates and trusts.

Reasons for change

There will be two significant tax increases in 1979 over 1978. First, social security taxes will go up as a result of legislation enacted last year. Second, inflation will cause an automatic tax increase. The committee believes there should be individual income tax reductions to offset these tax increases.

Rapid inflation has resulted in an increase in money incomes substantially in excess of the increase in real incomes. Because the income tax brackets are in terms of money income, inflationary increases in income move taxpayers into higher income tax rate brackets, reducing the amount of real income taxed in the lower tax brackets and increasing the portion of the real income owed as income taxes.

In addition, the committee believes that present law does not adequately recognize the economic status of single heads of households, who are generally low- or middle-income widows or divorced mothers with young children. To provide additional tax relief to single heads of households, the committee decided ot increase the zero bracket amount (standard deduction) for them from the $2,300 being made available to single persons to $3,000.

In the past Congress has used the standard deduction (the minimum standard deduction) and the personal exemption to establish a tax-free income level approximating the poverty income level. This policy began with the Revenue Act of 1964. The committee believes that a tax-free income level for married persons somewhat higher than the poverty level is needed in the next year to offset recent increases in food and other consumer prices.

The extent to which the zero bracket amount and the personal exemption determine a tax-free income level and the extent to which the tax-free level compares with projected poverty levels are shown for various taxpayers in table 4 below. For example, under present

law, the tax-free income level for a married couple is $5,200. (This amount is the sum of the $3,200 zero bracket amount plus two $750 personal exemptions plus two $35 general credits (which is equivalent to two $250 personal exemptions at the 14 percent income tax rate)). With the increase in the zero bracket amount to $3,400, the tax-free income level would be $5,400 in 1979. The amount ($5,400) is the sum of the $3,400 zero bracket amount and the two $1,000 personal exemptions provided by the bill without the $35 general tax credit which expires in 1978. This compares with the projected poverty income levels for a married couple of $4,662 in 1979 and $5,338 in 1981.

Table 4.—Tax-Free Income Levels Under Present Law and Committee Bill Compared to Projected Poverty Levels

	Tax-free levels		Projected poverty levels [1]	
	1978 law	H.R. 13511 for 1979 and thereafter	1979	1981
Single person	$3,200	$3,300	$3,605	$4,128
Couple without dependents	5,200	5,400	4,662	5,338
Family of 4 [2]	7,200	7,400	7,089	8,116

[1] Applicable to nonfarm families. Projections based on estimated 1977 levels and assumed increase in the consumer price index of 7 percent a year.
[2] Without regard to the earned income credit.

Explanation of provisions

The committee bill provides new tax rate schedules in place of each of the tax rate schedules of present law. The present law rate schedule and the new one provided by the bill for married couples filing joint returns are shown in table 5 below.

Increase in zero bracket amount

The first change from present law is the increase in the zero bracket amount in the joint return schedule from $3,200 to $3,400. The increase is from $2,200 to $2,300 for single persons, or one-half as much as for married couples. to avoid increasing the marriage tax penalty. For heads-of-households, the increase is $800, from $2,200 to $3,000. For married persons filing separate returns, the increase is from $1,600 to $1,700.

Because the zero bracket amount, in effect, builds the old standard deduction into the tax rate schedule, it is necessary to permit itemizers to claim only those itemized deductions in excess of that amount, if they are to be able to use the same tax rate schedule as nonitemizers. Otherwise, they would, in effect, get their itemized deductions *plus* the standard deduction amount. Thus, the bill also increases the present floor under itemized deductions by $200 for joint returns, $100 for single and separate returns, and by $800 for single head-of-household returns.

The provision includes a technical amendment to the income averaging provisions relating to the addition of the zero bracket amount to base period income for years before the adoption of the zero bracket system (i.e., pre-1977). The amendment specifies that the zero bracket amount increase of base period income is not to be the new zero bracket amount in this bill but is to remain at the existing level (i.e., $3,200 for joint returns, $2,200 for single individuals individuals and single heads of household and $1,600 for married individuals filing separately).

The House bill provided the same increases in the zero bracket amount for single and married taxpayers as the committee's bill but treated heads of households the same as single persons, an increase to $2,300.

Widening of tax brackets

A new tax rate schedule is provided with only 15 brackets for joint returns and 16 for single taxpayers, a reduction from the 25 brackets of present law. Consequently, the size of the remaining brackets is increased, particularly in the upper brackets, as shown in table 5. In addition, four tax rates are reduced by one or two points as indicated by an asterisk on that table.

The bracket widening and rate reductions are designed to offset, in each income class, the tax increase in 1979 over 1978 resulting from the scheduled social security tax increases and the implicit tax increase from the expected inflation (a 7-percent increase in the Consumer Price Index in 1979 over 1978).

The House bill contains a smaller tax rate reduction.

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Table 5.—Tax Rate Schedule Under Present Law and Committee Bill for Married Couples Filing Jointly [1]

Present Law

If the taxable income is:	The tax is:
Not over $3,200	No tax.
Over $3,200 but not over $4,200	14% of the excess over $3,200.
Over $4,200 but not over $5,200	$140, plus 15% of excess over $4,200.
Over $5,200 but not over $6,200	$290, plus 16% of excess over $5,200.
Over $6,200 but not over $7,200	$450, plus 17% of excess over $6,200.
Over $7,200 but not over $11,200	$620, plus 19% of excess over $7,200.
Over $11,200 but not over $15,200	$1,380, plus 22% of excess over $11,200.
Over $15,200 but not over $19,200	$2,260, plus 25% of excess over $15,200.
Over $19,200 but not over $23,200	$3,260, plus 28% of excess over $19,200.
Over $23,200 but not over $27,200	$4,380, plus 32% of excess over $23,200.
Over $27,200 but not over $31,200	$5,660, plus 36% of excess over $27,200.
Over $31,200 but not over $35,200	$7,100 plus 39% of excess over $31,200.
Over $35,200 but not over $39,200	$8,660, plus 42% of excess over $35,200.
Over $39,200 but not over $43,200	$10,340, plus 45% of excess over $39,200.
Over $43,200 but not over $47,200	$12,140, plus 48% of excess over $43,200.
Over $47,200 but not over $55,200	$14,060, plus 50% of excess over $47,200.
Over $55,200 but not over $67,200	$18,060, plus 53% of excess over $55,200.
Over $67,200 but not over $79,200	$24,420, plus 55% of excess over $67,200.
Over $79,200 but not over $91,200	$31,020, plus 58% of excess over $79,200.
Over $91,200 but not over $103,200	$37,980, plus 60% of excess over $91,200.
Over $103,200 but not over $123,200	$45,180, plus 62% of excess over $103,200.
Over $123,200 but not over $143,200	$57,580, plus 64% of excess over $123,200.
Over $143,200 but not over $163,200	$70,380, plus 66% of excess over $143,200.
Over $163,200 but not over $183,200	$83,580, plus 68% of excess over $163,200.
Over $183,200 but not over $203,200	$97,180, plus 69% of excess over $183,200.
Over $203,200	$110,980, plus 70% of excess over $203,200.

Committee Bill

If the taxable income is:	The tax is:
Not over $3,400	No tax.
Over $3,400 but not over $5,500	14% of excess over $3,400.
Over $5,500 but not over $7,600	$294, plus 16% of excess over $5,500.*
Over $7,600 but not over $11,900	$630, plus 18% of excess over $7,600.*
Over $11,900 but not over $16,000	$1,404, plus 20% of excess over $11,900.*
Over $16,000 but not over $20,200	$2,224, plus 24% of excess over $16,000.*
Over $20,200 but not over $24,600	$3,232, plus 28% of excess over $20,200.
Over $24,600 but not over $29,900	$4,464, plus 32% of excess over $24,600.
Over $29,900 but not over $35,200	$6,160, plus 38% of excess over $29,900.
Over $35,200 but not over $45,800	$8,174, plus 43% of excess over $35,200.
Over $45,800 but not over $60,000	$12,732, plus 49% of excess over $45,800.
Over $60,000 but not over $85,600	$19,690, plus 54% of excess over $60,000.
Over $85,600 but not over $109,400	$33,514, plus 59% of excess over $85,600.
Over $109,400 but not over $162,400	$47,556, plus 64% of excess over $109,400.
Over $162,400 but not over $215,400	$81,476, plus 68% of excess over $162,400.
Over $215,400	$117,516, plus 70% of excess over $215,400.

[1] And surviving spouses.
*Reduction from present rates.

Distribution of tax reduction

The reduction in tax and its distribution by income classes (at 1978 income levels) from the change in the tax rate schedule is shown in table 6 below.

Table 6.—Tax Reductions From Widening Tax Brackets, Rate Cuts, and Increased Zero Bracket Amount, 1978 Income Levels

Expanded income class [1]	Tax decrease		
	Amount (millions)	Percent of tax	Percentage distribution
Below $5,000	$97	16.8 [2]	.8
$5,000 to $10,000	1,064	12.9	9.0
$10,000 to $15,000	1,775	10.4	15.0
$15,000 to $20,000	2,168	9.0	18.3
$20,000 to $30,000	3,359	7.5	28.3
$30,000 to $50,000	2,148	5.5	18.1
$50,000 to $100,000	896	3.7	7.5
$100,000 to $200,000	270	2.1	2.3
$200,000 and over	92	.7	.8
Total	**11,868**	**6.4**	**100.0**

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

[2] As a percent of positive liability before offset for the refundable portion of the earned income credit.

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

Effective date

The change in the tax rate schedule, including the higher zero bracket amount, is effective for taxable years beginning after December 31, 1978.

The bill specifically applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow these taxpayers the benefits of the rate cuts and the increase in the zero bracket amount (as well as the increase in the personal exemption) for that part of their fiscal year which falls in 1979. In addition, the expiration of the general tax credit is treated as a change in the rate of tax. Under this provision, fiscal year taxpayers are to compute their tax liability for their full year both under 1978 law and 1979 law. With respect only to the provisions listed. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling in 1979.

The section 21 proration rule for fiscal year taxpayers (sec. 107 of the bill) is made available only for the changes listed above in the case of individuals (those changes made by sec. 101 and 102 of the bill, and the expiration of the general tax credit, sec. 42 of the Code) and for the corporate rate changes made by section 301 of the bill. The committee agrees with the House (the House bill provision is the same as the committee bill provision) that the proration rules should be limited to those cases where a computation would not be required because a taxpayer could use two sets of tax lookup tables, or the computation would be simple such as using two rate schedules. Any gain in equity that might result from making the section 21 rule broader is outweighed, in the committee's view, by the additional complexity that would be created for forms, instructions, and taxpayers themselves.

Revenue effect

The changes in the tax rate schedules, including the zero bracket amounts, are estimated to reduce calendar year liabilities by $13,239 million in 1979, $15,608 million in 1980, and $25,855 million in 1983. Budget receipts will be reduced by $8,034 million in fiscal year 1979, $14,694 million in fiscal year 1980, and $24,306 million in fiscal year 1983. These amounts include the revenue reduction from increasing the zero bracket amount for heads of households to $3,000 rather than $2,300 as follows: $467 million in calendar year 1979, $491 million in 1980, and $568 million in 1983; budget receipts will be reduced by $70 million in fiscal year 1979, $471 million in 1980, and $549 million in 1983.

3. Increase in the personal exemption (sec. 102 of the bill and secs. 151 and 6013(b)(3) of the Code)

Present law

Under present law, the amount of the personal exemption is $750 for the taxpayer, his or her spouse, and each dependent whose gross income is less than $750 (unless the dependent is a child of the taxpayer who is under age 19 or a student). An additional exemption is provided for a taxpayer who is blind or age 65 or over. Present law also provides a general tax credit, which is the larger of $35 per exemption or 2 percent of the first $9,000 of taxable income (in excess of the zero bracket amount), with a maximum credit of $180. The credit is scheduled to expire at the end of 1978.

Reasons for change

The personal exemption was last increased by the Tax Reform Act of 1969, from $600 (where it had been since 1948) to $750. The $750 exemption became effective in 1972. Inflation since then has eroded the real value of the $750 exemption and increased the difference between $750 and the cost of supporting a dependent. Consumer prices have in fact increased 55 percent since 1972. This erosion in the value of the exemption has been particularly severe for middle- and upper-middle income taxpayers, especially those with large families.

The committee concluded that an appropriate adjustment in the tax structure (in conjunction with the increase in the earned income credit, the increase in the zero bracket amount, and the tax bracket and rate changes discussed above) is to increase the personal exemption from

$750 to $1,000. This is intended as a replacement for the temporary general tax credit, which is permitted to expire at the end of 1978. The $35 per exemption credit provided by the general tax credit was the equivalent of an additional $250 worth of personal exemption at the bottom tax rate (14% x $250=$35). Therefore, the substitution of the $250 exemption increase for the credit will not increase the taxes of lower-income taxpayers and will result in a tax decrease for those who have income taxed at a rate higher than 14 percent and who elect the $35 credit rather than the 2-percent alternative credit. It does not affect the tax-free income level. This change (along with the tax rate and bracket changes) is designed to focus relief primarily on taxpayers who have been moved rapidly up the tax rate schedule due to inflation, particularly those with larger families where the increase in the cost of living has had the most severe impact.

While no taxpayers will experience a tax increase as a result of the replacement of the $35 per exemption credit by a $250 exemption increase, some taxpayers who elect the 2-percent-of-taxable-income alternative credit will have a tax increase which will not be offset by the rate changes in the bill. These are almost entirely single persons or married couples with no dependents who itemize their deductions. (For nonitemizers, the increase in the zero bracket amount prevents virtually any tax increases.) The overall effect of these changes is that only 109,000 taxpayers, or less than one percent of the total, will experience a tax increase from the combination of *these three* provisions. (About 1.2 million taxpayers will experience a tax increase from the entire bill.)

The committee also was concerned about two other aspects of the general tax credit, which contributed to the conclusion that a $250 increase in the personal exemption would be preferable. First, the general tax credit is an *additional* provision. Although most taxpayers do not have to compute it because it has been built into the tax tables, it is a source of complexity. Some taxpayers who cannot use the tax tables (generally because their income is in excess of $20,000 for single persons and $40,000 for joint returns) must compute the credit.

The existence of the general tax credit for even a few taxpayers requires 7 lines on the tax computation schedule (schedule TC) out of the 11 lines used for the tax computation. It also requires an explanation in both the regulations and instructions.

Second, the 2-percent alternative credit increases the marriage tax penalty that often results when two single persons with fairly equal earnings marry each other. Because both single persons and joint returns are each limited to a maximum credit of $180, a total of $360 for the two single taxpayers, they lose as much as $180 of general tax credit when they marry. The cutting back of the marriage penalty resulting from the general tax credit is what made it necessary to have many of the tax increases for single persons. (See table 3 above.)

Explanation of provision

The committee bill provides a permanent increase in the personal exemption from $750 to $1,000 and also increases the gross income limit for a dependent from $750 to $1,000. The general tax credit is allowed to expire at the end of 1978, as under existing law.

The income distribution of the revenue change from substituting a $1,000 personal exemption for the general tax credit is shown in Table 7 below. The tax increases shown result from the loss of the 2 percent of taxable income credit and generally are offset by the rate cuts.

The House bill contains an identical provision.

Table 7.—Tax Change From Substituting a $1,000 Personal Exemption for the General Tax Credit, 1978 Income Levels

Expanded income class [1]	Tax decrease	
	Amount (millions)	Percent of tax
Below $5,000	$15	10.9
$5,000 to $10,000	−184	−2.2
$10,000 to $15,000	−394	−2.3
$15,000 to $20,000	−94	−.4
$20,000 to $30,000	571	1.3
$30,000 to $50,000	765	1.9
$50,000 to $100,000	382	1.6
$100,000 to $200,000	95	.7
$200,000 and over	33	.2
Total	1,189	.6

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

NOTE.—A negative decrease is a tax increase.

Effective date

The increase in the personal exemption is effective for taxable years beginning after December 31, 1978. The general tax credit will no longer apply for taxable years ending after December 31, 1978.

As discussed above in relation to the rate cuts, the committee bill applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow these taxpayers the benefits of the personal exemption (as well as the rate cuts and increase in the zero bracket amount) for that part of their fiscal year which falls in 1979.

Revenue effect

The increase in the personal exemption, net of the expiration of the general tax credit, is estimated to reduce calendar year liabilities by $1,284 million in 1979, $1,397 million in 1980 and $1,708 million in 1983. Budget receipts will be reduced by $899 million in fiscal year 1979, $1,362 million in 1980, and $1,679 million in fiscal year 1983.

4. Additional personal exemption for the handicapped (sec. 107 of the bill and sec. 151 of the Code)

Present law

Under present law, there is no extra personal exemption provided for handicapped persons (as there is in the case of those who are blind or age 65 and over).

Reasons for change

Many handicapped individuals incur additional expenses because of their handicap. In many cases no tax relief is provided for these expenses because they do not qualify as medical expenses under the strict definitions of present law.

Consequently, the committee decided to provide an additional personal exemption to handicapped persons but to limit this additional exemption to those cases where an individual is not receiving tax-exempt disability income from any government program.

Explanation of provision

The bill provides an additional personal exemption to a handicapped taxpayer or a handicapped spouse of the taxpayer if the spouse has no gross income and is not the dependent of another taxpayer and a joint return is filed. A handicapped individual is defined as one who is permanently and totally disabled (as defined in section 72(m)(7) of the Code, which is essentially the same definition as in section 105 dealing with disability income which uses the same definition as provided in the Social Security Act). The additional exemption would not be available to an individual, however, if he or she received benefits as a disabled veteran, a disabled civil service employee, or receives cash benefits as a disabled person under the Social Security Act or other Federal, State or local government program. In addition, the extra exemption would not be available with respect to anyone age 65 or over, because the elderly are eligible for an extra exemption under present law.

The additional personal exemption is to be $500 rather than $1,000 for 1979 and 1980 and is to be increased to $1,000 for 1981 and thereafter.

The House bill has no comparable provision.

Effective date

The $500 additional exemption is to be available for taxable years beginning after December 31, 1978, and the $1,000 exemption is to be effective for taxable years beginning after December 31, 1980.

Revenue effect

The additional exemption for disabled persons will reduce calendar year tax liabilities by $242 million in 1979, $254 million in 1980 and $559 million in 1983. Budget receipts will be reduced by $121 million in fiscal year 1979, $248 million in fiscal year 1980 and $546 million in fiscal year 1983.

5. Changes in filing requirements and withholding changes (secs. 101 and 102 of the bill and secs. 6012(a) and 3402 (b) and (m) of the Code)

Present law

Under present law, a tax return must be filed by a single person and a head of household if his or her income is $2,950 or more a year and by a married couple filing a joint return if their income is $4,700 or more.

These amounts represent the zero bracket amount of $2,200 for single persons and heads of households and $3,200 for joint returns plus $750 for each personal exemption. (The filing requirements do not reflect the temporary general tax credit.) For each additional exemption resulting from the taxpayer or his spouse being age 65 or over, these amounts are increased by $750. Thus, a single person age 65 or over need not file until his or her income is $3,700 or more; a married couple, both under age 65, $4,700 or more; a married couple with only one spouse age 65 or over, $5,450 or more; and a married couple with both spouses age 65 or over, $6,200 or more.

The withholding tax rates reflect the present law tax rates, the zero bracket amount, and amount of the personal exemption.

Reasons for change

When the zero bracket amount and the amount of the personal exemption are increased, the income levels for filing a tax return should be conformed to the new tax-free income levels. Also, any such increases should be reflected in withholding changes.

Explanation of provision

The income levels at which a tax return must be filed are increased to reflect the increase in the zero bracket amount from $2,200 to $2,300 for single persons from $2,200 to $3,000 for heads of households and from $3,200 to $3,400 for joint returns and the increase in the personal exemption from $750 to $1,000. Consequently, the new filing level under the bill is $3,300 for a single person, $5,000 for a head of household and $5,400 for a married couple both under age 65, $6,400 if only one spouse is age 65 or over, and $7.400 if both spouses are age 65 or over.

The withholding rates and tables are to be changed by the Secretary of the Treasury to reflect the increase in the zero bracket amount and the personal exemption. The percentage method withholding table is changed to reflect the increase in the personal exemption (sec. 3402(b) of the Code). A conforming change is made in the provision under which additional withholding exemptions can be claimed for itemized deductions in excess of the zero bracket amount to reflect the increase in that amount and the amount of the personal exemption.

Effective date

The change in the filing requirement is effective for taxable years beginning after December 31, 1978, and the withholding changes apply to remuneration paid after December 31, 1978.

6. Changes in the earned income credit (secs. 103, 104, and 105 of the bill and sec. 43 of the Code)

Present law

Under present law, an eligible individual is allowed a credit against tax equal to 10 percent of the first $4,000 of earned income (for a maximum credit of $400). The amount of the credit is phased out as the adjusted gross income (or earned income, if greater) of an individual increases from $4,000 to $8,000. Under this phase-out, one dollar of credit is lost for each ten dollars of income in excess of $4,000, regardless of whether the individual has at least $4,000 of earned income. Because the credit is refundable, it may exceed an individual's income tax liability for the year. Thus, individuals with low incomes on which little or no tax is due may receive cash payments equal to the amount of the credit (reduced by any tax due).

Earned income eligible for the credit includes all wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment. Earned income is eligible for the credit, however, only if it is includible in the gross income of the taxpayer during the taxable year in which the credit is claimed. Amounts received as pension or annuity benefits may not be taken into account for purposes of the credit, and the credit is not available with respect to income of non-resident alien individuals that is not connected with a U S. trade or business.

An individual is eligible for the earned income tax credit only if that individual maintains a household in the United States for himself or herself and for one or more children who are under the age of 19, are students, or are disabled dependents. Further, in order to claim the credit, the individual must not be entitled to exclude any amounts from gross income under section 911 (relating to earned income from sources outside the United States) or section 931 (relating to income from sources within the possessions of the United States).

For purposes of the maintenance of household requirement, an individual is considered to be maintaining a household if he or she, (or, if married, the individual and his or her spouse) provide over half the cost of maintaining the household (including costs attributable to children who are dependents). Maintenance expenses of a household normally include items such as property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises.

Current law requires that the earned income credit not be taken into account as income for purposes of determining eligibility for, or the amount of, benefits or assistance under any Federal program or State or local program financed in whole or in part with Federal funds.

Presently, the credit is scheduled to expire at the end of 1978.

Reasons for change

The committee believes that the earned income credit is an effective way to provide work incentives and relief from income and Social

Security taxes to low-income families who might otherwise receive large welfare payments. The credit was enacted by the Congress in 1975 for two years and was subsequently extended for an additional year through 1978. Since the credit has proven to be an effective way to provide tax relief for low income families while at the same time providing work incentives for these individuals, the committee has decided to make the credit permanent.

The committee also considered the amount of the credit, which has not changed since 1975. Since the purpose of the credit has been to provide a work incentive, the committee believes it is appropriate to increase the amount of the credit to take into account the increase in the past several years of the cost of living, as well as current minimum wage levels. As a result, the committee's bill increases the credit so that it is equal to 12 percent of the first $5,000 of earned income (a maximum of $600), being phased out between $6,000 and $11,000 of income.

The committee also examined the administrative aspects of the earned income credit with a view to making it work more effectively and simply. The major concern that the committee focused on was the time at which eligible individuals can receive the benefit of the credit. Under present law an individual does not receive the benefit of the credit until the end of the year when he or she files the tax return. The committee believes that the credit can work more effectively if an individual is able to receive it during the year while he or she is working. This provides the tax relief at a time when the individual is more likely to need it. Therefore, the committee provides for advance payments of the credit to be made by employers to eligible employees. The committee believes that this new procedure will increase the work incentive that is intended to be provided by the credit.

The committee has also reviewed and agreed with the modifications adopted by the House which make it easier for both the eligible individuals and the Internal Revenue Service to determine eligibility for, and the amount of, the credit.

Finally, the committee repealed the provision that prohibits the credit from being taken into account for purposes of determining eligibility for an amount of Federal benefits, or for benefits under a State or local needs-tested program financed in whole or in part from Federal funds. The committee believes that in order for the earned income credit to be an effective incentive to work and a disincentive for being on welfare, the credit should be treated as earned income for purposes of the aid to families with dependent children and Supplemental Security Income programs.

Explanation of provision

Increase in the amount of the credit

The bill makes the earned income credit permanent, and increases the amount of the credit to 12 percent of the first $5,000 of earned income; this results in a maximum credit of $600. In recognition of the unusually high cost of living in Alaska and Hawaii, this dollar amount is adjusted upward by the ratio of the Office of Management and Budget official poverty line for any non-contiguous State to the poverty line for the 48 contiguous States, if this ratio is 15 percent or

greater. (The resulting figure could be rounded to the nearest multiple of $50.)[1]

For this purpose, an individual will be treated as a resident of a State if he maintains a household in that State and is physically present in that State for more than 210 days during the taxable year.

Simplification of the credit

The bill revises the income limitation on the credit, both to take account of the increase in the amount and to allow the credit to be determined directly from tables. Under current law, the actual amount of the allowable credit is reduced by one dollar for each ten dollars by which adjusted gross income (or, if greater, earned income) exceeds $4,000. Under the bill, however, the maximum allowable credit will be phased down as income rises above $6,000. Specifically, the allowable earned income credit for any taxable year will be limited to the excess of $600 over 12 percent of the excess of adjusted gross income (or, if greater, earned income) over $6,000. Thus, the credit is zero for families with incomes over $11,000.[2]

For example, a taxpayer with $4,000 of earnings and $7,500 of adjusted gross income would have an earned income credit of $420, which is the lower of (a) 12 percent of $4,000, or (b) $600 minus 12 percent of $1,500 ($7,500 minus $6,000). Under the type of phaseout in current law, the credit in this case would be $300 ($480 minus 12 percent of $1,500). Compared with the current law phaseout, this amendment affects only those individuals with earned income less than $5,000 and adjusted gross income greater than $6 000; these individuals will receive an increase in the amount of credit allowed.

The bill provides that the amount of the credit allowed is to be determined under tables prescribed by the Secretary. The committee intends that the taxpayer determine the credit amount by selecting the lower of two numbers, each of which is found in a separate table. The first table would use income brackets not greater than $50 each between zero and $11,000 and would show the credit allowed under the assumption that earned income equalled or exceeded adjusted gross income. The second table would reflect the credit allowable if earned income and adjusted gross income were at least $6,000, and if adjusted gross income were greater than, or equal to, earned income. The individual would apply his earned income to the first table to find a tentative credit amount and would apply his adjusted gross income (if greater than $6,000) to the second table to find a second tentative credit amount, and the actual credit allowed would be the lower of the two tentative credits.

In order to simplify the credit determination, the bill repeals the provision that earned income eligible for the credit does not include any items which are excluded from adjusted gross income. Currently, ex-

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[1] For example, the official poverty line for Alaska currently is 25 percent greater than the poverty line for the 48 contiguous States. Thus, for residents of Alaska, the earned income credit would be equal to 12 percent of the first $6,250 of earnings, for a maximum of $750.

[2] The $600 and $6,000 figures are subject to an adjustment for residents of noncontiguous States similar to that described in the previous paragraph. Thus, for residents of Alaska, the credit would not exceed the excess of $750 over 12 percent of $7,500.

cludible items such as excluded disability income and the rental value of a parsonage must be subtracted in determining earned income eligible for the credit. Under the bill, these subtractions will not be necessary.

The bill changes eligibility requirements for the credit so that individuals who are eligible for the credit can be identified from entries on the individual income tax return (Form 1040) after a slight modification in the form to identify heads of household who maintain a household for a child. These changes will allow the Service to give the credit to taxpayers who are eligible for the credit but who neglect to claim it. Any individual who is considered to be married and who is entitled to a dependency exemption under section 151 for a child, any surviving spouse, and any head of a household who maintains a household for a child generally will be eligible for the earned income credit. However, for a married individual, the dependent child must live in the individual's principal place of abode, which must be in the United States. For this purpose, the Service may use an individual's mailing address to determine whether the individual's principal place of abode is in the United States. The household which a surviving spouse or head of household must maintain in order to qualify for either status also must be in the United States if the individual is to qualify for the credit. As under current law, individuals entitled to exclude any foreign source income under sections 911 or 931 would be ineligible for the credit.

Compared with current law, the bill extends the credit to two small groups of taxpayers: (1) married couples and surviving spouses now denied the credit because the only dependent child living with them is over 18 and neither disabled nor a student, and (2) heads of household who qualify for that status on the basis of either a dependent or nondependent child in the same category. The bill would deny the credit to two other small groups: (1) married couples who qualify for the credit only because they have living with them a child who does not qualify for a dependency exemption and who is under 19 or a student, and (2) heads of household who now qualify for the credit only because they have living with them a married child who is either under 19 or a student.

Advance payment of the credit

The bill provides that an eligible individual may elect to receive advance payment of the earned income credit from his employer. Any individual who receives advance payments during a calendar year would be liable for the excess of such payments over the actual amount of the credit, which cannot be determined until the end of the year. Conversely, individuals whose advance payments for a year are less than the actual amount will be credited with the excess of the actual credit over the advance payments.[3]

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[3] Technically, the total amount of advance payments is to be treated as an additional amount of tax owed by the employee on his tax return, but the actual earned income credit is allowed in full against that tax liability. Thus, the taxpayer will have a net increase or decrease in tax, depending on whether his advance payments are greater or less than his actual credit. Any individual who receives advance payments would be required to file an income tax return.

An employee who believes that he is eligible for the credit may claim advance payments by providing the employer with a certificate on which the employee certifies that he expects to be eligible for the credit, that he does not have a certificate in effect with another employer, and whether or not the employee's spouse has a certificate in effect.

The Secretary will prescribe by regulation the form and contents of the certificate.[4] It should contain, however, a complete description of the conditions governing eligibility for the credit.

Any certificate remains in effect until revoked or until a new certificate takes effect. If the employee's spouse puts into effect or revokes a certificate with his employer, or the employee becomes ineligible for the earned income credit, the employee must revoke the certificate or furnish a new one.

For any employee with a certificate in effect, the employer is required to add the advance payment to the employee's paycheck. The advance payment would be reflected in the employee's W–2 form as a separate item; it would not be treated as a reduction of withholding. The amount would depend on the employee's earnings in the pay period, and would be determined from tables similar to those used for income tax withholding purposes. The table used for a particular employee would depend on whether or not the employee's spouse was also claiming advance payments. If the employee certifies that his spouse is not claiming advance payments, then the employer would use a table which would treat the earned income credit as less than or equal to a credit of 12 percent of the first $5,000 of earned income, phasing out (at a 12-percent rate) between $6,000 and $11,000 of income. If the employee certifies that his spouse is claiming advance payments, then the employer would instead use a table which would treat the earned income credit as less than or equal to a credit of 12 percent of the first $2,500 of earned income, phasing out between $3,000 and $5,500 of income.[5] The use of a separate table for those employees whose spouses are also claiming payment is intended to prevent advance payments for such individuals from exceeding the amount to which they are ultimately entitled. In other cases where the employee believes that the advance payments may be too large because they do not take into account other income (such as unearned income or income from a second

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[4] The certificate of an employee making his first application to the employer will take effect at the beginning of the first payroll period, or at the first payment of wages on or after the date on which the certificate is furnished. For subsequent certificates, however, the employer may delay putting the certificate into effect for at least 30 days, but no later than the next status determination date (January 1, May 1, July 1, or October 1) following the expiration of the 30-day period.

[5] For example, suppose that an individual works part-time with an annual wage of $4,800 and that the employer makes monthly wage payments of $400. If the individual's spouse is not claiming advance payments, then the employer would compute the advance payment from a table designed for this category of employee; the amount would be less than or equal to $48 (i.e., 12 percent of $4,800 divided by 12, the number of pay periods in the year). If the individual's spouse is claiming advance payments, then the table for this category of employee would be less than or equal to $7 (i.e., $300, minus 12 percent of ($4,800—$3,000), divided by 12).

job), the employee may offset a portion of the advance payment by increasing his ordinary income tax withholding. This can be accomplished simply by reducing the number of withholding allowances he claims on his withholding certificate. Furthermore, the Treasury is given the discretion to make advance payments of less than the full amount of the credit so that it can design the tables in such a way as to minimize the number of individuals whose advance payments are more than the actual credit to which they are ultimately entitled.

The aggregate amount of advance payments which the employer makes to employees in any pay period will be treated as payments, for that pay period, of withholding taxes on all employees, the employee share of FICA taxes, and the employer share of FICA taxes, in that order. Thus the amount of these payments which the employer will make to the Federal government will be reduced by the amount of advance payments.[6] If the aggregate amount of advance payments exceeds the total of these payroll taxes (which could occur for employers exempt from withholding, for example), then the employer may either reduce the amounts of advance payments to all eligible employees by a uniform rate in order to eliminate the excess, or he may treat the excess as advance payment of any other tax imposed under the Code. Employers who fail to make advance payments to an employee who furnishes a certificate shall be subject to the same penalty which would be imposed by the Code if the employer refused to withhold the same amount.

Treatment of credit as earned income

The bill repeals the provision in current law requiring that the credit be disregarded for purposes of cash or in-kind federal or federally-aided assistance programs. The committee believes that the credit should be treated as earned income, and the bill amends the provisions of the Social Security Act specifically to provide that the credit is treated as earned income in the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs.

This treatment applies both to the actual amount of advance payment and to the excess of the actual credit for a year over the total amount of advance payments for that year. (This excess cannot actually be received until the following calendar year.) In the case where the advance payments exceed the actual credit, so that the individual must return the difference, earned income for the purpose of these programs must be reduced by the amount of the difference.

The House bill contains the simplifying changes in the credit, but not the increase in the credit or the implementation of advance payments.

Effective date

The increase in the credit, the simplifying changes, and the requirement that employees who claim any advance payments must file tax returns apply to taxable years beginning after December 31, 1978. The advance payment provisions will be effective for remuneration

[6] Reduced payments of FICA taxes will not affect appropriations to the Social Security trust funds, since those appropriations are determined by FICA liabilities, not collections.

paid after June 30, 1979. The provisions providing that the credit be treated as earned income will be effective on the date of enactment of this Act.

Revenue effect

It is estimated that this provision will reduce calendar year tax liabilities and increase accrued outlays by $1,707 million in 1979, $1,639 million in 1980, and $1,450 million in 1983. Budget receipts will be reduced and outlays will be increased by $110 million in fiscal year 1979, $1,969 million in fiscal year 1980, and $1,497 million in fiscal year 1983.

Budget outlays will be increased by less than $1 million in fiscal year 1979, $994 million in fiscal year 1980, and $670 million in fiscal year 1983. These outlay increases will be offset by a reduction in public assistance outlays of $42 million in fiscal year 1979, $181 million in fiscal year 1980 and $203 million in fiscal year 1983. This results from treating the credit as earned income.

B. Itemized Deductions: Repeal of deduction for State-local nonbusiness gasoline and other motor fuel taxes (sec. 111 of the bill and sec. 164(a)(5) of the Code)

Present law

Under present law, an individual who itemizes deductions can deduct State and local taxes imposed on gasoline, diesel, and other motor fuels not used in business or investment activities (sec. 164(a)(5)). For example, taxes on gasoline consumed in personal use of a family car are deductible by an itemizer.

A taxpayer who purchases and uses gasoline for nonbusiness purposes may obtain the deductible amount of State gasoline taxes from tables printed in the instructions for the return (IRS Form 1040).[1] The table amounts are based on mileage driven during the year, the number of cylinders in the engine, and the gasoline tax rates in each State. Two or more calculations must be made from the tables if the tax rate in the particular State changed during the year, or if the taxpayer purchased gasoline in States having different tax rates. If an itemizer does not want to use the gasoline tax tables, or has purchased and used other motor fuels for nonbusiness purposes, he or she must obtain and keep receipts showing the exact amounts of State and local taxes paid.

Reasons for change

The committee believes that State-local gasoline taxes essentially constitute charges for the use of highways, comparable to the nondeductible Federal gasoline tax. Therefore, these taxes are more like personal expenses for automobile travel (as are highway tolls or the cost of gasoline itself) than like income or other general State-local taxes. To allow deduction of the gasoline tax is inconsistent with the user-charge nature of the tax, in that deductibility serves to shift part of the cost from the highway user to the general taxpayer.

The committee also believes that the availability of this deduction places recordkeeping burdens on those taxpayers who keep receipts

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[1] For taxpayers in Hawaii, county gasoline taxes must be calculated from receipts and added to the table amount.

for all motor fuel purchases (as is required except for State gasoline taxes) or keep records as to miles driven; and if the taxpayer fails to keep such records, the amounts claimed may be based on guesswork. In addition, the deduction (which is claimed by virtually all itemizers) presents audit difficulties for the Internal Revenue Service, since there is no ready way of gauging the correctness of the amount claimed from data on the return or from easily obtainable records, or of verifying mileage claims made by taxpayers using the gasoline tax tables. Accordingly, repeal of the deduction will help achieve tax simplification for taxpayers and will reduce audit problems for the IRS. Also, the average amount of tax savings to itemizers resulting from the present deduction is relatively small.

In addition, the committee believes that, in view of the pressing national need to conserve energy and reduce oil imports, the Federal Government should not, in effect, partially subsidize nonbusiness consumption of motor fuels through a deduction for State-local taxes on such fuels. The repeal of this deduction, therefore, is an indication that the Congress is concerned with gasoline consumption.

Explanation of provision

The bill repeals the itemized deduction for State and local taxes on gasoline, diesel, and other motor fuels not used by the taxpayer in business or investment activities.

The House bill includes an identical provision.

Effective date

The repeal of the deduction is effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will increase calendar year liabilities by $1,151 million in 1979, $1,358 million in 1980 and $2,231 million in 1983. Budget receipts will be increased by $471 million in fiscal year 1979, $1,237 million in fiscal year 1980, and $2,029 million in fiscal year 1983.

C. Credit for Political Contributions

(sec. 121 of the bill and sec. 41 of the Code)

Present law

Under present law (sec. 218), an individual who itemizes deductions can deduct political or newsletter fund contributions up to $100 per year ($200 in the case of a joint return). Contributions eligible for the deduction may be made to (1) candidates for nomination or election to Federal, State, or local office in general, primary, or special elections; (2) committees sponsoring such candidates; (3) national, State, or local committees of a national political party; and (4) newsletter funds of an official or candidate.

Alternatively, a taxpayer can elect an income tax credit equal to one-half of such political and newsletter fund contributions, but not more than $25 ($50 in the case of a joint return) (sec. 41). The credit cannot exceed the taxpayer's income tax liability as reduced by the

sum of any credits claimed for foreign taxes, for the elderly, and for investments in certain property.[1] An individual who does not itemize deductions can utilize the tax credit.

If an individual itemizes deductions and makes political contributions of $50 or less ($100 or less on a joint return), the credit generally will result in a greater tax benefit than the deduction, unless the contributor's marginal tax bracket is 50 percent or higher. For contributions of $100 or more ($200 or more on a joint return), the deduction (if the taxpayer itemizes) will result in a greater tax benefit than the credit, unless the contributor's tax bracket is less than 25 percent. To determine whether the credit or deduction will produce the greater tax benefit if a $50–$100 contribution is made ($100–$200 in the case of a joint return), taxpayers must calculate their tax both ways. The result will depend on the amount of the contribution, other items on the return, and the taxpayer's marginal income tax bracket.

Reasons for change

The committee believes that the credit for political contributions can be an effective means of encouraging individuals to participate actively in the electoral process by donating to the candidate or party of their choice. The credit, in effect, reduces the cost of an eligible contribution to the donor. In addition, it has the same value at all income levels, and is available regardless of whether the individual itemizes deductions. Moreover, since the maximum credit is small, it probably has the greatest incentive effect with respect to contributors of moderate amounts.

To further expand individual participation in the electoral process, through the encouragement of political contributions, the committee believes that it is appropriate to increase the maximum amount of the credit for political contributions.

Explanation of provision

The bill increases the maximum amount of the income tax credit for political contributions from $25 to $50 ($100 in the case of a joint return). In all other respects, the bill retains the limitations of present law on the credit's availability, and does not modify the alternative deduction for political contributions.

The House bill does not modify the present law credit for political contributions, but repeals the alternative itemized deduction in order to achieve simplification.

Effective date

This provision is effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $16 million in 1979, $26 million in 1980, and $16 million in 1983. Budget receipts will be reduced by nothing in fiscal year 1979, $16 million in fiscal year 1980, and $16 million in fiscal year 1983.

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[1] Apart from the political contribution deduction and credit provisions, the Federal Election Campaign Act allows a taxpayer to earmark $1 ($2 on a joint return) of his or her Federal income tax liability for contribution to the public financing of Presidential campaigns.

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D. Increase in Tax Credit for the Elderly

(Sec. 122 of the bill and sec. 37 of the Code)

Present law

Under present law, an individual taxpayer age 65 or older is entitled to a tax credit for the elderly equal to 15 percent of the credit base minus certain offsets. Currently, the credit base is:

$2,500_____ Single individual or joint return where only one spouse is eligible;
$3,750_____ Joint return where both the spouses are eligible; or
$1,875_____ Married individuals filing a separate return.

This credit base is reduced by certain amounts received as a tax-free pension or annuity (for example, under social security or the railroad retirement system). The credit base is also reduced by one-half of the adjusted gross income in excess of certain limitations.[1] These limitations are:

$7,500_____ Single individuals;
$10,000____ Joint returns; or
$5,000_____ Married individuals filing separate returns.

Reasons for change

Under present law, social security payments and benefits under the Railroad Retirement Act are tax exempt. A primary purpose of the credit for the elderly is to provide those who receive retirement income from other sources (such as a Federal, State or local government pension, or a private pension or annuity) with a tax benefit which is generally equivalent to the benefit of the exemption for social security and RRA income.[2] Another purpose is to provide tax relief to elderly taxpayers who continue to work. Because of the increases which have occurred in the level of social security retirement benefits, and because of recent increases in the cost of living which have particularly affected elderly taxpayers, the committee believes that it is appropriate to also increase the credit for the elderly. Thus, the committee's bill increases the amount of the credit base for individuals 65 years of age or older.

The increase in the credit base (and the increase in the phaseout level, discussed below) increase the tax threshold or tax-free income

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[1] Under present law, individuals under age 65 who have income from pensions and annuities under a public retirement system are also entitled to a retirement income credit equal to 15 percent of their credit base. The credit base for these individuals is generally the same amount as that set forth above for individuals age 65 or older. This credit base is also reduced by the amount of any tax-free pensions or annuities received from social security or the railroad retirement system. There is no adjusted gross income limitation for public retirement system employees under age 65. The committee bill does not change the present law retirement income credit for taxpayers under age 65.

[2] For this reason, when an individual receives both a taxable pension and tax-exempt retirement income, such as social security, the credit base is reduced by the amount of tax free retirement income which the individual receives.

level. These levels under present law and under the committee bill are shown below for a single person and a married couple:

	Single person age 65 or over	*Married couple, both age 65 or over*[1]
Present law	$6,410	$10,455
Committee bill	7,156	11,850

[1] Without regard to the earned income credit.

As indicated above, the credit for the elderly is phased out for individuals age 65 or older with adjusted gross income in excess of certain limitations. Thus, the individual's credit base is reduced by one-half of the amount by which the adjusted gross income exceeds the prescribed limitations. Under present law, a single individual with an adjusted gross income (assuming no social security income) of $12,500 or more would be completely phased out of the credit. In the case of a married couple filing a joint return, where both spouses are entitled to the credit, the phase-out would be complete if the couple had an adjusted gross income of $17,500 or more. In light of recent inflation, the committee believes that these limitations are too low. Accordingly, the committee's bill increases the adjusted gross income limitation.

Explanation of provisions

Increase in the credit base

Under the committee bill, a single individual who is age 65 or older would be entitled to a tax credit for the elderly equal to 15 percent of the credit base up to $3,000. Thus, the individual would be entitled to a maximum tax credit of $450. In the case of a married couple filing a joint return, where both spouses are eligible for the credit, the married couple would be entitled to a credit equal to 15 percent of their credit base up to $4,500. This would provide for a maximum credit of $675. Married individuals filing a separate return would be entitled to a credit at half this level, or 15 percent of the individual's credit base up to $2,250 (for a maximum credit of $337.50). As under present law, the credit base would continue to be reduced dollar-for-dollar by the amount of any tax-exempt social security retirement income or Railroad Retirement Act income received by the individual.

Increase in the adjusted gross income limitation

Under the committee bill, in the case of a single individual, the credit base would be reduced by one-half of adjusted gross income in excess of $15,000. This reduction takes place after the reduction of the credit base for social security income, if any. The following discussion assumes no social security income. For example, an individual having an adjusted gross income of $16,000 would be entitled to a tax credit for the elderly of $375. (Under the committee bill, the individual's credit base of $3,000 would be reduced by one-half of adjusted gross income in excess of $15,000 (or $500), leaving a credit base in this case of $2,500; 15 percent of $2,500 would allow the individual a tax credit

of $375.) The phase-out would be complete (that is, the individual would be entitled to no credit for the elderly) if adjusted gross income equaled $21,000 or more.

In the case of a married couple filing a joint return, under the committee bill, the phase-out of the credit would not begin until the adjusted gross income of the couple exceeded $17,500. There would not be a complete phase out of the credit, in the case of such a couple, unless their adjusted gross income equaled at least $26,500.

In the case of a married individual filing a separate return, the phase-out would begin if the individual's adjusted gross income exceeded $8,750; and there would be a complete phase-out if that individual's income was $13,250 or greater.

The benefit of these changes go almost entirely to lower and middle-income taxpayers. As shown in the table below, nearly half of the benefits go to those with income between $10,000 and $15,000, and nearly 94-percent goes to returns with incomes under $20,000.[4]

The House bill contains no comparable provision.

TAX DECREASE FROM COMMITTEE BILL INCREASE IN THE TAX CREDIT FOR THE ELDERLY

Expanded income [1]	*Number of returns with tax decrease (thousands)*	*Amount of tax decrease (millions)*	*Percentage distribution of tax decrease*
0 to $5,000	12	$0.2	(*)
$5,000 to $10,000	515	41.6	15.0
$10,000 to $15,000	665	134.7	48.4
$15,000 to $20,000	439	84.2	30.3
$20,000 to $30,000	160	12.8	4.6
$30,000 to $50,000	54	3.6	1.3
$50,000 to $100,000	13	.7	.2
$100,000 to $200,000	3	.1	(*)
$200,000 and over	1	.1	(*)
Total	1,863	278.0	100.0

* Less than 0.05 percent.
[1] Adjusted gross income plus tax preferences.

Effective date

This provision applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $278 million in 1979, $278 million in 1980, and $278 million in

[4] The table is based on expanded income (adjusted gross income plus tax preferences); a few returns with adjusted gross income under $25,000, for example, may have expanded income of $50,000 or $100,000 or more.

1983. Budget receipts will be reduced by $104 million in fiscal year 1979, $278 million in fiscal year 1980, and $278 million in fiscal year 1983.

E. Deferred Compensation Plans

1. State and local government deferred compensation plans (sec. 131 of the bill and sec. 457 of the Code)

Present law

Under present law, a taxpayer using the cash receipts and disbursements method (cash method) of accounting generally is not required to include compensation in gross income until it is actually or constructively received (sec. 451). However, under the constructive receipt doctrine, a taxpayer may not deliberately turn his back on income and thus select the taxable year for which the income will be reported. A taxpayer ordinarily will be deemed to have received income if he or she has a right to receive that income and the exercise of that right is not subject to substantial restrictions (Treas. Regs. § 1.451–2(a)).

In addition, under certain conditions, a taxpayer is required to treat the receipt of noncash benefits as income. Under the cash method, a taxpayer is required to report any item of income that is received in cash or in the form of a "cash equivalent." (Treas. Regs. §§ 1.61–2 (d), 1.446–1(a)(3) and 1.446–1(c)(1)(i).)

However, if the property transferred as compensation is subject to a substantial risk of forfeiture or is nontransferable, special rules are provided which defer income inclusion until the property first becomes transferable or not subject to a substantial risk or forfeiture (sec. 83). The same general rules which apply to the transfer of property in connection with the performance of services generally apply to funded, nonqualified deferred compensation arrangements (sec. 402(b)).

In applying the constructive receipt and cash equivalent doctrines to deferred compensation, an unsecured promise to make a future payment, not represented by a note, is not an item of gross income under the cash receipts and disbursements method.[1] Further, some courts have held that neither the constructive receipt doctrine nor the cash equivalent doctrine would be applied to a taxpayer merely because the taxpayer agreed with the payor in advance to receive compensation on a deferred basis rather than currently, as long as the agreement was made before the taxpayer had obtained an unqualified and unconditional right to the income.[2]

In 1960, the Internal Revenue Service published Revenue Ruling 60–31 [3] which set forth a broad policy statement regarding the applica-

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[1] *See Jackson* v. *Smietanka*, 272 F.970 (7th Cir. 1921); *E. F. Cremin*, 5 B.T.A. 1164 (1927), *acq.* VI–I C.B. 2 (1927); *C. Florian Zittel*, 12 B.T.A. 675, 677 (1928).

[2] *See James F. Oates*, 18 T.C. 570 (1952); *aff'd*, 207 F. 2d 711 (7th Cir. 1953), *acq.* (and prior *nonacq.* withdrawn) 1960–1 C.B. 5; *Howard Veit*, 8 T.C. 809 (1947), *acq.* 1947–2 C.B. 4; *cf. Kay Kimbell*, 41 B.T.A. 940 (1940), *acq.* and *nonacq.* 1940–2 C.B. 5, 12; *J. D. Amend*, 13 T.C. 178 (1949), *acq.* 1950–1 C.B. 1; *James Gould Cozzens*, 19 T.C. 663 (1953); *Howard Veit*, 8 CCH Tax Ct. Mem. 919 (1949).

[3] 1960–1 C.B. 174.

tion of the constructive receipt and cash equivalent doctrines to nonqualified deferred compensation arrangements.[4] Revenue Ruling 60–31 set forth a number of general principles regarding the constructive receipt and cash equivalent doctrines and then provided five examples of their application to deferred compensation arrangements.

The five examples set forth in the ruling made it clear that the constructive receipt and cash equivalent doctrines would not be applied to certain deferred compensation arrangements between an employee and an employer even though the employee might have obtained an agreement from the employer to make an immediate cash payment following the performance of services. Subsequent published rulings continued to confirm that the constructive receipt and cash equivalent doctrines would not be applied merely because an employee was permitted to elect, before the compensation was earned, to defer the compensation to a later time or receive it currently. In addition, some of these subsequent rulings indicated that a cash method employee would not be considered to have current income even though the employer set aside assets to fund its obligation to pay deferred compensation, as long as the employee did not acquire a present interest in either the amounts deferred or the assets used as the employer's funding medium.[5]

In 1972, the Internal Revenue Service issued the first favorable private letter ruling with respect to an unfunded deferred compensation arrangement where a State or local government unit was the employer.[6] Subsequently, many States and local governments have obtained private rulings with respect to their deferred compensation

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[4] At the same time the Service withdrew its prior nonacquiescence and acquiesced in the decision in *James F. Oates*, supra. See 1960–1 C.B. 5.

[5] See Revenue Ruling 68–99, 1968–1 C.B. 193, where the employer purchased an insurance policy on the life of the employee to insure that funds would be available to meet its obligation to make deferred compensation payments. The ruling held that the employee did not receive a present economic benefit when the employer purchased the insurance contract since all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable by the insurance company only to the employer.

See also Revenue Ruling 72–25, 1972–1 C.B. 127, where the employer funded its deferred compensation obligation with the purchase of an annuity contract.

[6] These deferred compensation plans typically involve an agreement between the employee and the State or local government, under which the employer agrees to defer an amount of compensation not yet earned. Frequently, these plans permit the employee to specify how the deferred compensation is to be invested by choosing among various investment alternatives provided by the plan. (However, the employer must be the owner and beneficiary of all such investments and the employee or his beneficiary cannot have a vested, secured, or preferred interest in any of the employer's assets.) Benefits under these plans (including gains and losses and investment income on investments made with the deferred compensation) typically are paid to the employees upon retirement or separation from service with the employer, or, in the case of the death of an employee, to the designated beneficiary. Typically, these plans provide also for the payment of benefits in case of an emergency beyond the employee's control. Many plans also provide for optional modes of distributing benefits (e.g., lump-sum payment or installments over 10 years) upon the occurrence of the event which causes benefits to be paid.

Where an unfunded plan is maintained by a governmental unit or a church, the plan can cover all or any part of an employer's work force. Under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), other employers can maintain such plans only to provide benefits in excess of those permitted under qualified plans, or to provide deferred compensation for a group of employees consisting primarily of highly compensated or management employees.

plans which provide that participating employees who use the cash method will include in income benefits payable under the deferred compensation plan only in the taxable year in which such benefits are received or otherwise made available.

In April 1977, the Internal Revenue Service stopped issuing private rulings dealing with the income tax treatment of individuals under certain unfunded deferred compensation plans, the type typically established by State and local governments, and began advising applicants for rulings that their applications would be delayed pending study. The plans involved permitted individuals to elect to defer a portion of salary that would otherwise be payable. Later, the Service publicly announced [7] the suspension pending a review of the area.

After completion of its review of this area, the Internal Revenue Service issued proposed regulations [8] which provide generally that, if under a plan or arrangement (other than a qualified retirement plan), payment of an amount of a taxpayer's fixed basic or regular compensation is deferred at the taxpayer's individual election to a taxable year later than that in which the amount would have been payable but for the election, the deferred amount will be treated as received in the earlier taxable year. These proposed regulations would apply to plans maintained by State and local governments, as well as plans maintained by and tax-exempt organizations and taxable employers.

Reasons for change

The committee believes that the regulations concerning nonqualified deferred compensation plans involving an individual election to defer compensation proposed by the Internal Revenue Service on February 3, 1978, if adopted in final form, would seriously impact upon the employees of many States and localities. If adopted, the regulations would prohibit employees of State and local governments from participating in salary-reduction deferred compensation plans as a means of providing retirement income.

Although the committee does not believe that State and local government employees should be totally prohibited from participating in unfunded deferred compensation plans, it believes that limitations should be imposed on the amounts of compensation that can be deferred under these arrangements and allowed to accumulate on a tax-deferred basis. Accordingly, the committee believes that a percentage-of-compensation limit on amounts that can be deferred, as well as an absolute dollar limitation to prevent excessive deferrals by highly-compensated employees, is necessary.

Explanation of provisions

The committee amendment adds a new provision to the Code (sec. 457) to provide certainty with respect to unfunded deferred compensation plans maintained by State and local governments. Thus, under this provision, employees and independent contractors who provide services for a State or local government that maintains an eligible de-

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[7] IR–1881 (9/7/77).

[8] Prop. Regs. § 1.61–16, published in the *Federal Register* for February 3, 1978 (43 F.R. 4638).

ferred compensation plan will be able to defer the receipt of compensation as long as such deferral does not exceed the prescribed annual limitations.

In general

Amounts of compensation deferred by a participant in an eligible State deferred compensation plan, plus any income attributable to the investment of such deferred amounts, will be includible in the income of the participant or his beneficiary only when it is paid or otherwise made available. For this purpose, the fair market value of any property (including an annuity contract or a life insurance policy) distributed to the participant from the plan will be includible in income. Amounts deferred are not "made available" solely by reason of the fact that an individual can elect, prior to the time he obtains an unconditional right to receive an amount of compensation, to defer some portion of it until a future date. In addition, amounts will not be considered "made available" merely because the participant is permitted to choose among various options that the plan may provide for the investment of deferred amounts, or to elect, prior to the earliest distribution date provided under the plan, the manner in which deferred amounts are to be paid. Of course, if a participant actually assigns or alienates his benefit under a plan, the benefit is made available to him. If life insurance is purchased with some, or all, of the amounts deferred under the plan, the cost of current life insurance protection will not be considered made available as long as the State or local government (1) retains all of the incidents of ownership of the policy, (2) is the sole beneficiary under the policy, and (3) is under no obligation to transfer the policy or to pass through the proceeds of the policy, as such, to the participant or a beneficiary of the participant. However, if the plan provides a death benefit, whether or not funded by the employer through the purchase of life insurance on the participant, any such death benefit will not qualify for exclusion from gross income as life insurance proceeds under section 101(a) of the Code. Instead, the committee intends that any death benefit will be taxed in accordance with the deferred compensation rules to the recipient.

Plan requirements

To qualify as an eligible State deferred compensation plan, the plan must be maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or one of its political subdivisions and must limit participation to *individuals* who perform services for it (i.e., partnerships and corporations cannot be participants).[9] In addition, the plan by its terms must not allow the deferral of more than $7,500, or 33⅓ percent of the participant's includible compensation for the taxable year, whichever is less.

Includible compensation (rather than gross compensation) is used in determining the percentage of an employee's compensation that

[9] While any deferred compensation arrangement between a State or local government and a partnership or service corporation would benefit the partners or shareholders who actually provide the services, it was considered unnecessary to extend the availability of such arrangements to these entities since they can provide deferred compensation through funded tax-qualified plans. In addition, a service corporation can maintain a nonqualified unfunded arrangement (without any limitations on the amount that can be deferred) for the benefit of its employees.

may be deferred because of the necessity of coordinating with the provisions of section 403(b) which also are based on includible compensation. In addition, there may be contractual deferred compensation arrangements where only includible compensation is readily determinable. For example, if a consultant agrees to provide service to a State agency for one year in return for current payments of $25,000 plus payments of $5,000 per year for an additional five years, such payments to begin after a period of ten years, it is clear that includible compensation is $25,000, but until the present value of the right to receive the additional $5,000 per year for 5 years is determined, compliance with the percentage limitation cannot be determined. (See discussion in *Present value of compensation* below.) Also, from the terms of the contract it generally would not be possible to tell how much compensation the consultant could have received in the year the services were performed ("gross compensation") but for the agreement to take periodic payments beginning at a later date.

For most employee-participants in the typical deferred compensation arrangement maintained by States or local governments, the determination of the permissible amount of deferral will not be burdensome since the compensation to be received for a particular year will be fixed by statute or contract and the employee will enter into a salary-reduction agreement with the employer that will specify how much is to be deferred. In the typical arrangement, the 33⅓ percent-of-includible-compensation limitation is equal to 25 percent of the compensation that would be received but for the salary reduction agreement. For example, an employee who is scheduled to receive $12,000 during a taxable year could enter into a salary-reduction agreement and elect to defer $3,000 (25 percent of gross compensation of $12,000 and 33⅓ percent of includible compensation of $9,000).

An eligible State deferred compensation plan may provide a limited "catch-up" provision for any, or all, of the last three taxable years of a participant ending before the normal retirement age specified by the plan (or if no normal retirement age is specified by the plan, then either the later of the normal retirement age specified in any other retirement plan maintained by the sponsoring entity or age 65.) Under the catch-up provision, in addition to the amount that may be deferred under the usual $7,500 and 33⅓-percent-of-includible-compensation limitations, a participant may defer an additional amount equal to any deferral limitations not utilized for prior taxable years in which the participant was eligible to participate in the plan (even if nothing was deferred) and was subject to the deferral limitations imposed by the bill. The maximum amount that can be deferred in any taxable year through the utilization of both the normal deferral limitation and the catch-up provision is $15,000. (Of course, the deferred amount also cannot exceed the amount of the participant's compensation from the State, etc.) For example, a 62-year-old participant in a plan with a normal retirement age of 65 who is scheduled to receive a salary of $20,000 during the next taxable year, could elect to defer $15,000 of that compensation if prior year's deferral limitations have been underutilized by at least $10,000. (The regular limitation is $5,000 ($20,000 minus $5,000 deferral) divided by 3 equals $5,000; the catch-up amount is $10,000 ($15,000 minus $5,000).)

The underutilized deferral limitation for a taxable year is the difference between compensation actually includible in income for that year and compensation that would have been includible in income if the maximum deferral limitation had been utilized. For example, an individual with a salary of $20,000 who did not elect to defer any compensation would have an underutilized deferral limitation of $5,000 ($20,000 minus $15,000 (includible compensation if the 33⅓ percent deferral limitation had been utilized)). In calculating the underutilized deferral limitation, the participant must use the actual plan limitations if they are less than the limitations provided by this bill.

In addition to providing limitations on amounts of compensation that can be deferred, the bill provides that the plan must not permit participants to defer compensation for a calendar month unless an agreement providing for such deferral has been entered into before the beginning of such month.

An eligible State deferred compensation plan cannot make benefits available to participants before the earlier of (1) separation from service with the sponsoring entity,[10] or (2) the occurrence of an unforseeable emergency. While the Secretary of the Treasury is to prescribe regulations defining what constitutes an unforeseeable emergency, it is not intended that such term would include the purchase of a home or the need for funds to send children to college. In addition, it is expected that plans will permit the withdrawal of only the amount of funds reasonably needed to satisfy the emergency needs.

Finally, for the deferred compensation plan to be eligible under the bill, all amounts of compensation deferred under the plan, all property or rights to property (including rights as a beneficiary of life insurance protection) purchased with the amounts deferred, and any income earned on property purchased with amounts deferred must remain assets of the plan sponsor subject to the claims of its general creditors. Thus, while plan participants may select among any optional methods provided under the plan for investing amounts of deferred compensation, they cannot have any secured interest in the assets purchased with their deferred compensation and the assets may not be segregated for their benefit in any manner which would put them beyond the reach of the general creditors of the sponsoring entity.

Any plan which is not administered in accordance with the bill's requirements for eligible State deferred compensation plans will lose its eligible status on the first day of the first plan year beginning more than 180 days after written notification by the Secretary of the Treasury that such requirements are not being met, unless satisfactory corrective action is taken by the first day of such plan year. If a plan loses its status as an eligible State deferred compensation plan, amounts subsequently deferred by participants will be includible in income when deferred (unless the amounts are subject to a substantial risk of forfeiture when deferred). However, it is intended that amounts previously deferred, and any earnings thereon, will still not be includible in income until paid or otherwise made available.

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[10] The Secretary of the Treasury will prescribe by regulations what constitutes "separation from service" for an independent contractor.

Participants in more than one eligible plan, or in a section 403(b) annuity

Except for the limited "catch-up" provision, $7,500 is the maximum compensation that can be deferred in a taxable year by an employee or an independent contractor who is a participant in an eligible State deferred compensation plan. This dollar limitation applies at the individual level, as well as at the plan level. Thus, if a person participates in more than one eligible plan (whether or not maintained by the same sponsoring entity) he must determine how the $7,500 limitation will be allocated among the various plans in which he participates. If the $7,500 limitation is exceeded, all excess amounts deferred for the taxable year will be currently includible in income.

If an individual participates in an eligible State deferred compensation plan and also has amounts contributed by an employer for the purchase of a tax-sheltered annunity or mutual fund shares held in a custodial account, and part or all of such contributions are excludable under section 403(b), the contributions excludable under section 403(b) reduce both the $7,500 and the 33⅓ percent of includible compensation limitations. For example, a public school official with a contract salary of $30,000 in his or her first year of service with the school system could be eligible to participate in both an eligible State deferred compensation plan and a tax-sheltered (section 403(b)) annuity plan (with all contributions assumed to come from salary reductions) sponsored by the employer. If the employee elected to participate in the tax-sheltered annuity plan to the maximum extent possible while still participating in the eligible deferred compensation plan, he or she could elect to defer $4,500 under section 403(b) for contributions used to purchase an annuity contract or mutual fund shares and $3,000 under the eligible State deferred compensation plan.[11]

For purposes of determining the exclusion allowance under section 403(b), any amount deferred in a prior taxable year of the employee under an eligible State deferred compensation plan (without regard to the sponsoring entity) will be treated as an amount contributed by the employer for annuity contracts and excluded by the employee, if

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[11] The applicable limitations would be computed as follows:

(1) Sec. 403(b) exclusion for the tax-sheltered annuity—20%×$22,500 (includible compensation after reduction of contract salary for salary reductions deferred under both plans)×1 (one year of service)=$4,500. (There is no reduction under sec. 403(b)(2)(A)(ii) for amounts contributed in prior years by the employer and excludable by the employee, since this is assumed to be the first year of service with the school system.) (The includible compensation of $22,500 used in computing the limitations was determined by multiplying the contract salary of $30,000 by 25 percent and subtracting that result ($7,500) from $30,000 since it was assumed that the maximum deferral possible was obtained by the employee.)

(2) The sec. 457(b)(2) limitation (limitation on deferral under an eligible State deferred compensation plan) is $3,000, which is the lesser of—

(a) $7,500, or

(b) 33⅓%×$22,500 (includible compensation after reduction of contract salary by deferral under both plans,

(c) $7,500, as determined under (b), reduced by the exclusion of $4,500 under sec. 403(b)=$3,000.

the taxable year of deferral counts as a year of service in the computation of the exclusion allowance under section 403(b).[12]

Treatment of participants in an ineligible plan

If a State or local government deferred compensation plan fails to meet the requirements of an "eligible" plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture. If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the gross income of participants or beneficiaries in the first taxable year there is no substantial risk of forfeiture.

While amounts deferred under an ineligible State deferred compensation plan generally would be included in income in the year of deferral, earnings credited on such deferred amounts would not be subject to current taxation as long as the participant has no interest in the assets of the State or local government sponsoring the plan which is more secure than that of general creditors. Where the participant has no such interest, earnings on amounts deferred under the plan will not be taxable to the participant until paid or otherwise made available and then will be taxed according to the annuity rules (sec. 72). Of course, the distribution of an annuity contract purchased with the earnings will be taxable (based on the fair market value of the contract) just as if it had been distributed from a nonqualified pension or profit-sharing plan. This is also the treatment that will be accorded any excess deferrals under an eligible plan and the earnings thereon.

The tax treatment of participants in an ineligible State deferred compensation plan does not extend to participants in the State's regular retirement plan (whether or not qualified under § 401(a)). In addition, such treatment is not applicable whenever section 83 or 402(b) apply to the taxation of deferred compensation.

Present value of compensation

The bill provides that compensation shall be taken into account at its present value. This rule was provided for those cases where the amount of deferral for a particular taxable year is not readily ascertainable.

In the case of the normal salary reduction deferral agreement entered into by an employee and a State or local government, the amount withheld by the State or local government will be considered to be the present value of the compensation deferred. This amount will then

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[12] In the example contained in footnote 11, if in year 2 the employee still had a contract salary of $30,000 and elected to defer the maximum amount possible under a tax-sheltered annuity while not taking advantage of the deferral under an eligible State deferred compensation plan, the exclusion allowance under sec. 403(b) would be $3,214.28, computed as follows:

(a) 20% × $26,785.72 (includible compensation) = $5,357.14

(b) × 2 years of service = $10,714.28

(c) less $7,500 ($4,500 excluded under sec. 403(b) in the prior taxable year and $3,000 deferred under an eligible State deferred compensation plan in the prior taxable year)

(d) maximum exclusion allowance = $3,214.28 (assuming no deferral under the eligible State deferred compensation plan in year 2).

be compared to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied for the taxable year. However, in the case of an independent contractor who agrees to perform services during a taxable year in return for some compensation payable currently and additional compensation payable in a later taxable year, it will be necessary, as of the close of the taxable year, to determine (without regard to any restriction other than one having a substantial risk of forfeiture) the present value of the right to receive the future payment or payments and compare that to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied.

If future payments are subject to a substantial risk of forfeiture, then they will not be valued until there is no longer a substantial risk of forfeiture. At the close of the first taxable year in which the future payments are no longer subject to a substantial risk of forfeiture, the present value of such payments must be compared to the includible compensation for such year to determine if the deferral limitations have been met.

The House bill contains the same provisions concerning eligible State deferred compensation plans (with minor technical changes), except that the House bill provided the same treatment for plans maintained by tax-exempt rural electric cooperatives and certain of their tax-exempt affiliates.

Effective date

All plans to which this provision applies (whether currently in existence or not) will have until January 1, 1982, to satisfy the plan requirements for classification as an eligible State deferred compensation plan. It is believed that this transitional rule will provide State legislatures with ample time to adopt necessary amendments to their enabling statutes. However, the limitations on amounts that can be deferred under such a plan will apply for all taxable years beginning after December 31, 1978. In addition, the catch-up provisions will apply prior to 1982 only if all State deferred compensation plans in which a participant is participating, or has participated in during taxable years for which there is an underutilized deferral limitation, are "eligible" State deferred compensation plans (i.e., all plans involved actually satisfy the plan requirements of sec. 457(b)).

Revenue effect

This provision continues the existing tax treatment of these types of plans within certain limitations, and therefore it has a negligible revenue effect.

2. Private nonqualified plans (sec. 132 of the bill)

Present law

The present law treatment of amounts deferred under unfunded, nonqualified deferred compensation plans maintained by taxable entites and tax-exempt organizations is basically the same as the treatment of amounts deferred under unfunded nonqualified deferred compensation plans maintained by State and local government units. However, unfunded deferred compensation plans maintained by these entities do differ in that, under Title I of the Employee Retirement

Income Security Act of 1974, they are limited to providing benefits in excess of those permitted under tax-qualified plans, or their coverage must be limited primarily to highly compensated and managerial employees.

The proposed regulations [1] issued by the Internal Revenue Service on February 3, 1978, would have applied to nonqualified deferred compensation plans maintained by these entities, as well as to those maintained by States and local governments. Much uncertainty has developed in the private plan sector because of the statement in the preamble to the proposed regulations that, if the regulations were adopted in final form, the Internal Revenue Service's acquiescenses in the decisions in *James F. Oates* [2] and *Ray S. Robinson* [3] would be reconsidered. The Service also indicated that it would be necessary to examine the facts and circumstances of cases similar to those described in several published revenue rulings to determine whether the deferral of payment was in fact at the individual option of the taxpayers who earned the compensation.

One of the published rulings singled out by the Service involved a five-year employment contract between an employer and an executive employee under which a specified amount of compensation was to be credited to a bookkeeping reserve, accumulated, and then paid out in five equal annual installments beginning when the employee either (1) terminated employment with the employer, (2) became a part-time employee, or (3) became partially or totally incapacitated.[4] Because the example cited by the Service involved an employment contract and not an annual election to defer compensation, uncertainty exists in the private plan sector as to the effect of the proposed regulations.

Reasons for change

The committee believes that the doctrine of constructive receipt should not be applied to employees as would be provided in the proposed regulations concerning nonqualified deferred compensation plans issued by the Internal Revenue Service on February 3, 1978. The committee also believes that the uncertainty surrounding the status of deferred compensation plans of both taxable and tax-exempt organizations caused by the proposed regulations is not desirable and should not be permitted to continue.

Explanation of provisions

The provision provides that the taxable year for including compensation deferred under a deferred compensation plan maintained by a taxable entity or a tax-exempt organization is to be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. It is intended that these principles are to be determined without regard to the proposed deferred compensation regulation under section 61 of the Code which was published in the Federal Register for February 3, 1978.

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[1] Prop. Treas. Regs. § 1.61–16, at 43 F.R. 4638.
[2] 18 T.C. 570 (1952).
[3] 44 T.C. 20 (1965).
[4] Example 1 of Revenue Ruling 60–31, 1960–1 C.B. 174.

This provision is not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.

The House bill provides that the principles of law in effect on February 1, 1978, are to be used to determine the timing of income inclusion by participants in unfunded deferred compensation arrangements maintained by taxable entities. However, it does not extend such treatment to participants in such plans maintained by tax-exempt organizations.

Effective date

This section is effective for taxable years ending on or after February 1, 1978.

Revenue effect

This provision will have a negligible effect upon budget receipts.

3. Payments to independent contractors (sec. 133 of the bill and secs. 404(b) and 404(d) of the Code)

Present law

Under present law, an employer generally is permitted a deduction for deferred compensation provided under a nonqualified plan in the year that such compensation is includible in the employee's gross income [1] even though the employer is on the accrual basis and normally would be entitled to a current deduction. This rule applies to any method of contributions or compensation having the effect of a plan deferring the receipt of compensation.[2] However, it does not generally apply to an accrual basis taxpayer who defers payment of compensation until after the year of accrual, where the amount payable cannot be determined exactly until the later year (e.g., year-end bonuses which are computed as a percentage of pre-tax profits).

Under present law, the rule permitting a deduction for deferred compensation only when there is a corresponding income inclusion by a plan participant applies only where there is an employer-employee relationship. Thus, an accrual basis taxpayer generally is able to establish an unfunded deferred compensation plan for a cash basis independent contractor and obtain a deduction for such liability in accordance with the usual accrual accounting rules.

Reasons for change

The committee believes that the rules regarding the deductibility of deferred compensation should be the same whether employees or independent contractors are deferring the receipt of compensation.

The committee also wishes to make it clear that any nonqualified plan or arrangement which results in a deferral of the receipt of compensation is subject to the deferred compensation deduction-timing rules (sec. 404).

Explanation of provisions

The bill adds a new provision (sec. 404(d)) which denies a deduction for deferred compensation provided under a nonqualified plan

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[1] Sec. 404(a)(5); Treas. Regs. § 1.404(a)–12(b).

[2] Treas. Regs. § 1.404(b)–1.

to non-employee participants, including cash-basis corporations, until that compensation is includible in the gross income of the participants. This rule is not intended to apply to normal year-end compensation accruals which are paid within a reasonable time after the close of the taxable year.

The bill clarifies current law by providing that a method of compensation or employer contributions having the effect of a plan deferring the receipt of compensation does not have to be similar to a stock bonus, pension, profit-sharing, or annuity plan to be subject to the deferred compensation deduction-timing rules (sec. 404). Under the bill, amounts of compensation deferred under an employment contract or year-end bonuses declared by a corporate board of directors, but not paid within a reasonable period of time after the close of the taxable year, would be subject to the deduction-timing rules of section 404 to the extent that another Code provision (e.g., sec. 267(a)(2)) does not operate to deny the deduction).

The House bill contains an identical provision.

Effective date

The amendments made by this section will apply to deductions for taxable years beginning after December 31, 1978.

Revenue effect

This provision will have a negligible effect upon budget receipts

4. Tax treatment of cafeteria plans (sec. 134 of the bill and sec. 124 of the Code)

Present law

Under a "cafeteria plan" or "flexible benefit plan" an employee may choose from a package of employer-provided fringe benefits, some of which may be taxable (e.g. group-term life insurance in excess of $50,000) and some of which may be nontaxable (e.g., health and accident insurance). Under a provision of the Employee Retirement Income Security Act of 1974 (ERISA), an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, is required to be included in an employee's gross income only to the extent that the employee actually elects taxable benefits. In the case of a plan not in existence on June 27, 1974, the employer contribution is required to be included in income to the extent the employee could have elected taxable benefits. Under the Tax Reform Act of 1976, these rules apply with respect to employer contributions made before January 1, 1978. Both the House- and Senate-passed versions of the Tax Treatment Extension Act, H.R. 9251, contain a provision which would extend these rules to employer contributions made before January 1, 1980.

Reasons for change

The provision in ERISA which prevents an employee from receiving tax-free treatment with respect to contributions to a cafeteria plan not in existence on June 27, 1974, and the provision of the 1976 Act extending the ERISA provision until January 1, 1978, were intended to be temporary and to allow further Congressional study of the tax treatment of cafeteria plans. The committee believes that rules for the treatment of these plans should now be provided on a permanent basis.

Explanation of provisions

General

Under the bill, generally, employer contributions under a written cafeteria plan which permits employees to elect between taxable and nontaxable benefits are excluded from the gross income of an employee to the extent that nontaxable benefits are elected. For this purpose, nontaxable benefits include group-term life insurance up to $50,000 coverage, disability benefits, accident and health benefits, and group legal services to the extent such benefits are excludable from gross income, but do not include deferred compensation.

The bill limits plan participation to individuals who are employees. In this regard, the committee intends that a plan may include former employees as participants and may provide benefits for beneficiaries of participants.

Under the bill, in the case of a highly compensated employee (an employee who is an officer, a more-than-5-percent shareholder, or within the highest paid group of all employees, or an employee who is a spouse or dependent of such an individual), amounts contributed under a cafeteria plan will be included in gross income for the taxable year in which the plan year ends, to the extent the individual could have elected taxable benefits unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility for participation in the plan and with respect to contributions or benefits.

Coverage and eligibility

A cafeteria plan will be considered to meet the coverage standards of the bill if it benefits a classification of employees found by the Secretary of the Treasury not to discriminate in favor of highly compensated employees. The plan will meet the eligibility standards of the bill if it (1) does not require an employee to complete more than three consecutive years of employment in order to become eligible to participate, and (2) allows an employee who is otherwise eligible to participate to enter the plan as a participant not later than the first day of the first plan year beginning after the date the employee completes three consecutive years of employment.

Contributions or benefits

The bill provides that a cafeteria plan must not discriminate as to contributions or benefits in favor of highly compensated employees. A plan will not be discriminatory if total benefits and nontaxable benefits attributable to highly compensated employees, measured as a percentage of compensation, are not significantly greater than total benefits and nontaxable benefits attributable to other employees (measured on the same basis), provided the plan is not otherwise discriminatory under the standards of the bill.

In the case of a cafeteria plan which provides health benefits, the bill provides that the plan will not be treated as discriminatory if: (1) contributions on behalf of each participant include an amount which equals either 100 percent of the cost of health benefit coverage under the plan of the majority of highly compensated participants who are similarly situated (e.g., same family size), or are at least equal to 75 percent of the cost of the most expensive health benefit coverage

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elected by any similarly situated plan participant, and (2) the other contributions or benefits provided by the plan bear a uniform relationship to the compensation of plan participants. Of course, the committee intends that a cafeteria plan will not be considered to be discriminatory where the other contributions or benefits provided (or total contributions or benefits in the case of a plan which does not provide health benefits) for a highly compensated employee are a lower percentage of that employee's compensation than the plan provides for employees who are not highly compensated.

Under the bill, a plan is considered to meet all discrimination tests if it is maintained under an agreement which the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers.

In testing a cafeteria plan for discriminatory coverage of employees and discriminatory contributions or benefits, the bill provides that all employees who are employed by a commonly controlled group of businesses are treated as if they were employed by a single employer. The rules for aggregating employees of businesses under common control are the same as the rules which are used in testing tax-qualified pension plans for discrimination (sec. 414 (b) and (c)). The committee intends that, where an employer maintains two or more cafeteria plans, the employer may choose to have the plans considered as a single plan for purposes of the discrimination tests.

The House bill contains an identical provision except for minor technical changes.

Effective date

The amendment is effective for taxable years beginning after the December 31, 1978.

Revenue effect

This provision will have no effect upon budget receipts.

5. Tax treatment of cash or deferred arrangements (sec. 135 of the bill and new secs. 402(a)(7) and 410(b)(3) of the Code)

Present law

Under present law, the benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated, and the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. In the case of a tax-qualified cash or deferred profit-sharing plan, the employer gives an employee the choice of (1) being paid a specified amount in cash as current compensation, or (2) having that amount contributed to the plan. Rev. Rul. 56–497, 1956–2 C.B. 284 upheld the tax-qualified status of a cash or deferred profit-sharing plan where, in operation, over one-half of the employees who elected profit-sharing contributions (deferral), rather than current compensation, were among the lowest paid two-thirds of the employees who had met the plan's 3-year eligibility requirement. (See also Rev. Rul. 63–180; 1963–2 C.B. 189, and Rev. Rul. 68–89, 1968–1 C.B. 402.)

On December 6, 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of employees

covered by cash or deferred profit-sharing plans. These proposed regulations were withdrawn in July, 1978.[1] Under the rules in effect at the time of the proposal, an employee was not taxed currently on amounts he chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.

In order to allow time for Congressional study of this area, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, is governed under the law as it was applied prior to January 1, 1972,[2] and this treatment was to continue at least through December 31, 1976, or (if later) until regulations are issued in final form in this area, which would change the pre-1972 administration of the law. Section 2006 of ERISA provides that these regulations, if issued, are not to be retroactive for purposes of social security taxes or the Federal withholding taxes, and are not to be retroactive prior to January 1, 1977, for Federal income tax purposes.

In the case of plans not in existence on June 27, 1974, contributions to a cash and deferred profit-sharing plan are treated as employee contributions (until January 1, 1977, or until new regulations are prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law before Congress has determined what the law should be in the future.

The Tax Reform Act of 1976 (sec. 1506) extended the temporary freeze of the status quo until January 1, 1978, in order to allow additional time for Congressional study of this area.[3]

Reasons for change

Since the enactment of ERISA the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1 1977. The committee believes that the uncertainty caused by the present state of the law has created the need for a permanent solution which permits employers to establish new cash or deferred arrangements. Also, the committee believes that present law discriminates against employers who had not established such arrangements by June 27, 1974.

Explanation of provision

The committee's bill adds new provisions to the Code (secs. 402(a)(7) and 410(b)(3)) to permit employers to establish tax-qualified cash or deferred profit-sharing plans (or stock bonus plans). In addi-

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[1] The committee understands that the withdrawal of the proposed regulations was not intended to represent a change in the Internal Revenue Service's position.

[2] Accordingly, employer contributions to these cash or deferred profit-sharing plans are not includible in the income of covered employees, provided the plans satisfy the requirements of pre-1972 law and otherwise comply with the standards of the Code for tax-qualified plans.

[3] The Tax Treatment Extension Act (H.R. 9251), different versions of which passed the House and the Senate, contains a provision which would extend the freeze of the status quo until January 1, 1980.

tion, it provides a transitional rule to permit plans in existence on June 27, 1974 to rely on certain pre-1972 revenue rulings until plan years beginning in 1980.

The bill provides that a participant in a qualified cash or deferred arrangement will not have to include in income any employer contribution to the plan merely because he could have elected to receive such amount in cash instead. For the cash or deferred arrangement to be a tax-qualified plan, it must satisfy the normal pension plan qualification rules. In addition, it must satisfy the following requirements: (1) it must not permit the distribution of amounts attributable to employer conributions merely because of the completion of a stated period of plan participation or the passage of a fixed period of time (unlike profit-sharing plans in general, where distributions may be made in the third calendar year following the calendar year of the employer's contribution), and (2) all amounts contributed by the employer pursuant to an employee's election must be nonforfeitable at all times.

Special nondiscrimination rules are provided for these arrangements in lieu of the normal rules to test for discrimination as to actual plan participation or as to contributions to the plan. Under these rules, a cash or deferred arrangement will meet these nondiscrimination requirements for qualification for a plan year if (1) the actual deferral percentage for the highest paid one-third of all participants does not exceed the deferral percentage for the other eligible employees by more than 50 percent, or (2) the actual deferral percentage for the highest paid one-third of all participants does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. (If this latter test is used, the actual deferral percentage for the highest paid one-third cannot exceed the actual deferral percentage of all other eligible employees by more than 150 percent. Paid one-third of all participants, only amounts considered as compensation under the provisions of the plan are taken into account. Therefore, the plan would have to have participation by employees in the lower paid group in order to obtain any deferral for the highest paid one-third.

The House bill, which was designed as a temporary solution, would have permitted new cash or deferred arrangements to be tax-qualified if they satisfied the law with respect to cash or deferred arrangements as it was administered before January 1, 1972.

Effective date

The amendment is effective for taxable years beginning after December 31, 1979; however, a transitional rule is provided for those cash or deferred arrangements in existence on January 27, 1974 under which their qualified status for plan years beginning before January 1, 1980 shall be determined in a manner consistent with Rev. Rul. 56–497 (1956–2 C.B. 284), Rev. Rul. 63–180 (1963–2 C.B. 189), and Rev. Rul. 68–89 (1968–1 C.B. 402).

Revenue effect

This provision will have a negligible effect upon budget receipts.

F. Employee Stock Ownership Plans

(secs. 141–145 of the bill and secs. 4975 and 404 and new secs. 44C and 416 of the Code)

Present law

ESOPs in general

An employee stock ownership plan (ESOP) is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay on their parts, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees. The employee generally is not taxed on employer contributions to an ESOP until they are distributed under the plan.

Under an ESOP, an employee stock ownership trust generally acquires common stock of the employer. (An ESOP may also acquire other equity securities of the employer, as well as certain bonds, debentures, notes and other evidences of indebtedness.) Under the general definition of an ESOP, stock is acquired either through direct employer contributions or with the proceeds of a loan made to the ESOP. (sec. 4975(e)(7)) Although a plan, by its design, may fit within the general definition of an ESOP, the plan is not required to meet the special rules applicable to ESOP's unless it engages in an otherwise prohibited loan from (or guaranty by) a disqualified person. (sec 4945(d)(3))

Under present regulations, an employee who receives a distribution of stock from an ESOP, where the stock was acquired with loan proceeds, must have a "put option" (i.e., an option to require the employer to repurchase the stock) if the stock is not publicly traded.

TRASOPs

Under present law, a corporate employer is entitled to an additional percentage point of investment credit (11 percent rather than 10 percent) if it contributes an amount equal to the additional credit to an ESOP which satisfies the requirements of the Tax Reduction Act of 1975 (a TRASOP). Up to ½ percent of extra investment tax credit is allowed where an employer contributes the extra credit amount to the TRASOP and the employer's extra contribution is matched by employee contributions. The present law provision for TRASOP contributions expires after December 31, 1980.

All TRASOPs must meet certain statutory requirements. Among these are that an employee who participates in the TRASOP at any time during the year for which an employer contribution is made is entitled to have a share of the employer contribution credited to his or her TRASOP account based upon the amount of the employee's compensation from the employer.[1] Also, each participant's right to stock credited to his or her TRASOP account must be nonforfeitable at all times. And, a plan participant must be entitled to direct the voting of employer stock allocated to his or her account under a TRASOP,] whether or not such stock is publicly traded.[2]

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[1] Only the first $100,000 of an employee's compensation is considered for this purpose.

[2] There is no voting requirement with respect to stock held by an ESOP.

In addition to these requirements which must be met by all TRASOPs, a TRASOP can be a tax-qualified plan if it meets the other requirements applicable to tax-qualified retirement plans. However, TRASOPs are not required to do so. Even if a TRASOP is not a tax-qualified plan it must satisfy certain special rules with respect to employee participation and limitations on contributions and benefits which are the same as those for tax-qualified retirement plans.

A TRASOP must be an established plan within the taxable year for which the additional investment tax-credit is claimed in order to be considered a tax-qualified plan for that year. However, a TRASOP may be established by the date for filing the employer's tax return for a year (including extensions) in order for the additional investment credit to be claimed for the year. In such a case, the TRASOP is nevertheless nonqualified for such year.

The employer's contribution to a TRASOP must be in the form of employer securities or cash (provided the cash is used by the TRASOP to acquire employer securities). The securities contributed to (or purchased by) a TRASOP must be common stock with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock of the issuing corporation. Securities convertible into such common stock could also be contributed.

An employer may contribute stock of another corporation to a TRASOP, provided that the two corporations are under at least 80 percent common control. However, gain or loss may be recognized by a subsidiary where an allocation of its parent's stock is made to employees' accounts under a TRASOP.

The credit amount contributed to a TRASOP reduces an employer's income tax liability. This may result in an increased minimum tax liability,[3] even though the amount of tax savings does not result in a direct benefit to the employer because it was offset by the contribution to the TRASOP.

Where the full amount of investment tax credit is not allowed for a year (because of the statutory limitations on the amount allowed for any year), the contribution with respect to the additional credit can be made to the plan as the balance is allowed. If the investment credit is carried back from the year of the investment for which the credit is originally claimed to a prior year, the additional investment credit which is allowed as a result of the carryback is contributed to a TRASOP for the year of the investment and is allocated to plan participants in the same manner as if it had been allowed in the year of the investment. However, where the credit is carried forward there is no requirement with respect to the manner in which the credit is allocated to plan participants.

Where an investment credit amount for a year is recaptured with the result that the investment tax credit for the year is later decreased, the employer has three alternatives with respect to adjusting the TRASOP contribution: (1) the amount of the decrease can be applied to offset employer contributions for other years; (2) the amount of the decrease can be deducted; or (3) the amount of the decrease can be recovered from the TRASOP.

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[3] The investment tax credit reduces the tax liability offset to the total amount of preference income.

Certain distributions from tax-qualified plans

Under present law, a death benefit distribution from a tax-qualified plan (including tax-qualified ESOPs and TRASOPs) which is eligible to be treated as a lump-sum distribution [4] is not eligible for the estate tax exclusion (sec. 2039(c)). This denial of the estate tax exclusion applies whether or not the recipient actually elects to treat the distribution as a lump-sum distribution to which favorable income tax treatment applies.

Under present law a participant in a tax-qualified plan who receives a lump sum distribution from the plan or a distribution on account of plan termination may avoid current tax by making a rollover contribution to an IRA (or to another qualified plan). Generally, in order to qualify for tax-free rollover treatment, the individual must contribute to the IRA the amount of money plus all of the assets received from the qualified plan. A participant is not accorded tax-free rollover treatment if he or she sells the distributed property and then contributes the cash proceeds to an IRA.

Reasons for change

The ESOP provisions and the TRASOP provisions have now been part of the tax laws for several years. Experience in the operation of these provisions has indicated that several changes are appropriate. In addition, based on experience since the Tax Reduction Act of 1975, the committee has determined that the TRASOP provisions should be made permanent and should be made a part of the Code.

Different sets of statutory and administrative rules have developed with respect to TRASOPs from those rules which apply to tax-qualified plans in general. The committee believes that the interests of uniformity would best be served if, in general, TRASOPs were required to become tax-qualified under the same standards generally applicable to tax-qualified plans. This equirement also will help employees maintaining TRASOPs to obtain interpretations of statutory provisions, since long-standing interpretations are available with respect to many of the rules governing tax-qualified plans.

Often an employer will not establish a TRASOP for a year until the time prescribed by law for filing its return for the year (including extensions) since, under present law, the TRASOP does not have to be established before that time for the employer to claim the additional investment tax credit. Because of the requirement that a tax-qualified plan be established by the close of a taxable year in order to be tax-qualified for that year, many TRASOPs are not tax-qualified for their initial plan year. Since tax qualification for these TRASOPs for the first year for which the additional investment tax credit is claimed is required under the bill, the committee believes that a TRASOP established on or before the due date for an employer's tax return for a year (including extensions) should be treated as tax-qualified for that year. The committee does not intend, however, to change the present law rule requiring that tax-qualified plans other than TRASOPs be established before the close of a taxable year to be tax-qualified for that year.

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[4] Generally, lump-sum distributions are eligible for favorable income tax treatment.

The committee believes that undue complexity has resulted from the present law provision requiring that contributions to TRASOPs be allocated to plan participants irrespective of their service with the new employer for that plan year.

The committee now recognizes that giving participants in TRASOPs full voting rights with respect to shares allocated to their accounts may be unduly burdensome in the case where the corporation issuing the employer securities is closely held. However, the committee recognizes the general need for voting rights under not only TRASOPs, but also ESOPS, even in the closely held situation where major corporate issues (such as mergers, acquisitions, consolidations, or sales of all or substantially all of a corporation's assets) are involved.

Many closely held subsidiary corporations are unable to establish TRASOPs with the stock of their parent corporations because the parent corporations do not meet the 80-percent stock ownership requirement of present law. The committee believes that this 80-percent requirement is unduly restrictive and that the interests of the public in broader stock ownership would better be served by a 50-percent stock ownership requirement. At the same time, it is believed that a 50-percent requirement will provide a sufficient identity of interests between parent corporations and subsidiary corporations to make it reasonable to consider the stock of the parent corporations as employer securities of the subsidiary corporations.

The TRASOP provisions of present law permit subsidiary corporations to make contributions to TRASOPs of stock of their parent corporations. However, gain or loss may be recognized with respect to such contributions. Since it is intended that TRASOP contributions result in an additional investment tax credit to a contributing employer, it is inappropriate for that credit to be offset by gain on a taxable contribution, and the committee therefore has determined to provide that gain or loss will not be recognized in such situations.

In certain cases, the additional investment tax credit attributable to TRASOP contributions can increase an employer's minimum tax liability. The committee believes that this reduction in the measure of tax benefit which TRASOP contributions are intended to produce is inappropriate.

The committee believes that in certain instances it is appropriate to permit distributions other than in the form of employer stock from ESOPs and TRASOPs, but that a plan participant should be entitled to demand the receipt of employer stock if the participant so desires.

The committee believes that the present law rule that TRASOP contributions are not required until the additional investment tax credit is actually utilized is inappropriate. The committee believes that a contribution should be made and allocated with respect to the year of the qualifying investment so that individuals then employed by the employer may benefit from the contributions and any growth attributable to the investment.

Because the TRASOP provisions originally were to expire on December 31, 1980, employers have been unable to rely on the ability to apply an excess TRASOP contribution created by recapture of investment tax credit against TRASOP contributions for future years.

Accordingly, present law allows employers to withdraw such excess TRASOP contributions in the event of recapture of investment tax credit. Since the committee has determined that the TRASOP provisions should now be made permanent, the committee believes that this provision for withdrawal of such excess contributions is no longer necessary.

The committee believes that any participant (or beneficiary) who receives a benefit distribution from an ESOP or a TRASOP (attributable to an ESOP loan or an additional investment tax credit should be able to convert that stock interest in the employer to its cash equivalent. In fact, the committee recognizes that in the usual situation this conversion occurs almost simultaneously with the actual distribution. The committee believes that the administrative paper-work and expense which is required for the ESOP or TRASOP to make a distribution in stock and then immediately repurchase the stock for cash is unwarranted in most situations. Accordingly, the committee believes that this process should be simplified when the participant desires to receive this ESOP or TRASOP benefit in cash. However, if a participant wishes to actually receive this ESOP or TRASOP benefit in stock of the employer, and retain ownership of this stock, he should be able to do so, and he should have the future right to convert that stock interest to its cash equivalent through a "put option" to the employer or to the trust under the ESOP or the TRASOP. The committee believes that the terms of this "put option" should not create a hardship for the participant, the ESOP or TRASOP, the employer or its shareholders.

Employees receiving a distribution of securities from a plan often have difficulty in making a rollover contribution to an IRA. This problem arises because the current rollover rules require that the actual assets distributed from the plan be rolled over. IRA trustees often are unwilling to accept employer securities. Even where the trustees are willing to accept employer securities an employee may be compelled to exercise a put option where the securities involved are shares of stock in a closely held corporation. Accordingly, the committee believes that an employee should be permitted to rollover to an IRA the proceeds from the sale of employer securities received in a qualifying distribution.

Explanation of provisions

General

The bill (1) makes several amendments to the TRASOP and ESOP provisions of present law, (2) makes the TRASOP provisions, as amended, part of the Code for the first time, and (3) makes the TRASOP provisions permanent by repealing the present law December 31, 1980, expiration date.

Qualification requirements for TRASOPs

Under the bill, all TRASOPs are required to be tax-qualified plans. This represents a departure from the present law provision for nonqualified TRASOPs which meet certain specified statutory standards. The committee expects that the regulations which generally apply to tax-qualified plans will henceforth also apply to TRASOPs, and that the Treasury Department will not write separate regulations regard-

ing the application of the tax-qualification standards to TRASOPs, except where TRASOPs are distinguished from other qualified plans by statute.

Under the bill, a TRASOP may be treated as tax-qualified from its effective date even though the TRASOP is not actually established until the date for filing the employer's tax return for its taxable year (including extensions).

Allocation of TRASOP contributions

Because under the bill, TRASOPs are subject to the same qualification requirements generally applicable to tax-qualified plans, employer contributions to a TRASOP for a plan year generally are not required to be allocated to those plan participants who are not employed on the last day of the plan year, except to the extent that a failure to allocate contributions to such employees would result in prohibited discrimination. As under present law, the allocation of employer TRASOP contributions for a year must be made in proportion to total compensation of all participants sharing in the allocation for the plan year, taking into account only the first $100,000 of compensation for an employee. As under present law, a TRASOP is not permitted to integrate with Social Security.

Provisions relating to employer securities

Under the bill, if an ESOP or TRASOP holds employer stock issued by a corporation whose stock is "publicly traded", the plan must provide that the stock is to be voted by the plan participants. In addition, the stock must provide for voting and dividend rights equivalent to the rights possessed by shareholders of the highest class of stock of the issuing corporation which is "readily available" on a public market. Shares of stock will not be deemed to be "readily available" if in a particular year there are only occasional sales of this stock on a national or regional securities exchange or quoted on NASDAQ. If an ESOP or TRASOP holds employer stock issued by a corporation which is closely-held, the plan must provide that the plan participants will be entitled to vote the stock with respect to corporate issues which must by law (or charter) be decided by more than a majority vote of common shareholders (such as a merger, acquisition, consolidation, or sale of all or substantially all of a corporation's assets).

In addition, the bill requires the Treasury Department to conduct a 1-year study and to prepare a report to the committee with respect to the extent to which voting rights and different forms of financial disclosure should be given to participants in ESOPs and TRASOPs which hold employer stock issued by closely-held corporations, and with respect to the resale rights which should be available to a participant (or beneficiary) who receives a distribution of employer stock from an ESOP, a TRASOP stock bonus plan. In conducting its study the Treasury Department is expected to consult with the Department of Labor, congressional staffs, and representatives of private businesses.

The bill provides that in the case of an ESOP under which the borrowing of funds from a third party is permitted for the purpose of acquiring employer securities, and in the case of a TRASOP, the only types of employer securities which may be acquired and held by the

plan are common stock of the issuing corporation and preferred stock of the issuing corporation which is readily convertible into its common stock.

The bill modifies the definition of employer securities for purposes of the TRASOP provisions by applying a 50-percent test in lieu of the present law 80-percent test in determining whether corporations are members of the same parent-subsidiary controlled group. Under the bill, stock of a parent corporation in a parent-subsidiary controlled group of corporations (determined by applying the 50-percent test) may be contributed as employer securities by another member of the group. The bill does not disturb the present law rule under which an 80-percent test is applied in the TRASOP employer securities definition in determining whether corporations are members of the same brother-sister controlled group.

The bill provides that in a case where a parent corporation and a subsidiary corporation (including a second tier subsidiary) are members of an affiliated group of corporations, the subsidiary corporation will not recognize gain or loss on a contribution to a TRASOP maintained by it of stock in the parent corporation.

Minimum tax

The bill provides that in any case where an employer claims additional investment tax credit as a result of a TRASOP contribution, the additional credit will not result in the imposition of additional minimum tax on the employer. The bill makes no change in the present law provision which increases the base for computing the minimum tax for each dollar of investment tax credit (other than investment tax credit attributable to TRASOP contributions).

Timing of TRASOP contributions

The bill requires that an employer maintaining a TRASOP make its TRASOP contribution for the year in which the investment giving rise to the additional investment tax credit is made, although the credit may not actually be used until a later taxable year. This represents a change in the present law rule permitting the making of TRASOP contributions when the credit is used rather than for the taxable year in which the investment is made. The committee believes that individuals employed by the employer during the year a qualified investment is made should be permitted to share in the growth of the company attributable to the investment.

Special rule for contributions attributable to one-half percent TRASOP credit

With respect to the employer TRASOP contribution, attributable to an extra one-half percent of additional investment tax credit for a year, the bill requires an employer to make such contributions to the extent that matching employee contributions are made. The employer is allowed to claim the credit with respect to such employer TRASOP contributions in the year for which the contributions are matched by employee contributions. This could result in an amount of investment tax credit being contributed to a TRASOP for a year which exceeds 1½ percent of the qualified investment for the year. An employee is given a two-year period beginning with the close of the employer's

taxable year for which the investment to which the credit relates was made to make his or her matching employee contributions.

Deduction of TRASOP contributions

In any case where the credit for a TRASOP contribution expires, a deduction is allowed for the amount of the expired credit in the year in which the credit expires.

Prohibition of withdrawal of TRASOP contributions on recapture

The bill repeals the present law rule which permits an employer to withdraw from a TRASOP a contribution attributable to additional investment tax credit which is recaptured. Under the bill, a TRASOP contribution made with respect to a particular qualified investment may not be withdrawn if all or a portion of the credit is later recaptured due to an early disposition of the property the purchase of which gave rise to the credit. The bill does not change the present law provision which permits the employer to either (1) deduct the amount of the contribution attributable to the recaptured additional investment tax credit for the taxable year in which the recapture occurs, or (2) apply the amount of the contribution attributable to the recaptured additional investment tax credit against its obligation for a future TRASOP contribution.

Distributions from ESOPs and TRASOPs

Under the bill, a participant in an ESOP or a TRASOP who is entitled to a distribution under the plan is given the right to demand that the distribution be made in the form of employer securities rather than in cash. Subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest to him in cash, in employer securities, or partially in cash and partially in employer securities. The committee feels that each participant (or beneficiary) must be advised in writing of the right to require a stock distribution before the ESOP or TRASOP may actually elect to distribute cash.

Put option on ESOP or TRASOP stock

Under the bill, any participant (or beneficiary) who receives a distribution of employer stock attributable to an ESOP loan or an additional investment tax credit must be given a "put option" on the employer stock distributed to him or her, provided that this employer stock is not publicly traded or is subject to a trading limitation when distributed, as these terms are defined in the Treasury regulations issued on September 2, 1977. The put option which a participant (or beneficiary) receives on shares of employer stock distributed from an ESOP or TRASOP should have the following terms:

1. Upon receipt of the employer stock, the distributee must have up to six months to require that the employer repurchase this stock, at its fair market value. Although the obligation to repurchase stock under the put option would apply to the employer, not the ESOP or the TRASOP, it is permissible for the ESOP or TRASOP to actually make the purchase in lieu of the employer. If the distributee does not exercise the put option within the six-month period, the option will temporarily lapse.

2. After the close of the employer's taxable year in which the temporary lapse of a distributee's put option occurs, and following a determination of the value of the employee stock (determined in accordance with Treasury regulations) as of the end of that taxable year, the employer will notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer stock. Each such distributee will then have up to three months to require that the employer repurchase his or her shares of employer stock. If the distributee does not exercise this put option, then the employer stock will not be subject to a put option in the future.

3. At the option of the party repurchasing employer stock under the put option, such stock may be repurchased on an installment basis over a period of five years. If the distributee agrees, the repurchase period may be extended to a period of ten years. As security for the installment repurchase, the seller must at least be given a promissory note, the full payment of which could be required by the seller if the repurchaser defaults in the payments of a scheduled installment payment. In addition, if the term of the installment obligation exceeds five years, the employee must be given adequate security for the outstanding amount of the note.

4. Because a distributee might wish to contribute the ESOP or TRASOP distribution to an IRA in a "tax-free" rollover and because the contribution would have to be made before the expiration of the first six-month put option period, under the bill, the IRA trustee must be able to exercise the same put option as the actual distributee.

Certain distributions from tax-qualified plans

Under the bill, the amount of a distribution which is a death benefit distribution from a qualified plan which is eligible to be treated as a lump sum distribution is excludible from the estate of the deceased plan participant only in situations where the recipient of the distribution agrees in writing not to elect to treat the distribution as a lump sum distribution eligible for special favorable income tax treatment.

The bill changes the present law rules that an employee who receives a distribution of employer securities from a qualified plan must always contribute the employer securities to an IRA in order for the contribution to qualify as a tax-free rollover contribution to an IRA. The bill permits an employee who receives employer securities, as part of a lump sum distribution from a qualified plan or as part of a complete distribution upon termination of a qualified plan, to receive tax-free rollover treatment by contributing the proceeds from the sale of the stock rather than the stock itself to an IRA within 60 days from the date of the distribution.

Effective date

The TRASOP provisions apply under present law through December 31, 1980. The bill makes these provisions permanent. In addition, the modifications to the ESOP and TRASOP rules under the bill generally are effective after December 31, 1978.

Revenue effect

Since the TRASOP provisions apply under present law until 1980, there is no revenue effect from making these provisions permanent

until after 1980. (The modifications to the provisions under the bill have only an insignificant revenue effect since they are primarily intended to make the existing provisions work more effectively.) By making the TRASOP provisions permanent, it is estimated that this provision will reduce calendar year liabilities by $396 million in 1981, $508 million in 1982, and $592 million in 1983. Budget receipts will be reduced by $178 million in fiscal year 1981, $446 million in fiscal year 1982, and $545 million in fiscal year 1983.

G. Retirement Plan Provisions

1. Deduction for employee retirement savings contributions (Sec. 151 of the bill and Sec. 221 of the Code)

Present law

An employee is generally entitled to deduct the amount contributed to an individual retirement account or annuity or used to purchase individual retirement bonds (referred to collectively as "IRAs"). The limitation on the deduction is the lesser of 15% of compensation for the year or $1,500 ($1,750 in the case of contributions to a spousal IRA). However, an individual is not entitled to such a deduction for a taxable year if he or she is an active participant during any part of the taxable year in a qualified retirement plan, a tax-deferred annuity maintained by a tax-exempt institution, or a governmental plan (whether or not qualified).

Many qualified plans provide for contributions by both the employer and the employee. In many such cases, the employee contributions are mandatory (either as a condition of employment or as a condition of participation in the plan). In other cases, employee contributions are voluntary, and their amount is left within limits to the discretion of the employee. A plan can also provide for both mandatory and voluntary employee contributions. In any case, neither employer nor employee contributions to a qualified retirement plan may discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, in the case of voluntary employee contributions, there is no discrimination so long as there is an equal opportunity for all employees to make such contributions. Income allocable to an employee's contributions to a qualified plan is not taxed to the plan or the employee prior to the time the income is distributed or made available to the employee or his or her beneficiary. However, the employee is not entitled to a deduction or exclusion for the amount of his or her contributions to the plan.

In the case of tax-deferred annuities (including custodial accounts investing in mutual fund shares) maintained by certain tax-exempt institutions, employees are entitled to exclusions from gross income for amounts contributed on a salary reduction basis.

Reasons for change

As a result of the provisions of the Code precluding IRA deductions where an employee is an active participant in a qualified plan, an active participant in such a plan may not make a deductible IRA contribution, even though the employer's contribution to the plan on his or her behalf might be quite small or the individual might never vest in a retirement benefit because of frequent changes in jobs.

The treatment of employee contributions to most qualified plans varies widely in comparison to the treatment of such contributions to some other tax-favored employee benefit arrangements, such as tax-deferred annuities maintained by educational organizations and certain tax-exempt institutions, "cash or deferred" profit sharing plans (a specific type of qualified plans), and unfunded salary reduction arrangements maintained by State and local governments.

The committee believes that changes are necessary in order to make the operation of the IRA program more uniform and to increase the incentives for employees to save for their own retirement. Therefore the committee has adopted a provision which will allow an employee who participates in a private qualified retirement plan maintained by his or her employer to deduct contributions either to that plan or to an IRA. This provision will tend to resolve the differing treatment accorded to employees whose employers do and do not maintain qualified plans, but will also create a tax incentive for increased retirement savings and provide more uniform rules for the treatment of employee contributions to tax-favored arrangements. The provision will result in such contributions being made on a nondiscriminatory basis, so that tax benefits and economic benefits will be apportioned among employees at all income levels rather than being concentrated among higher income employees.

Explanation of provision

Under the bill, an active participant in a qualified retirement plan may make a deductible contribution either to that plan or to an IRA. However, deductions for contributions are not available to participants in government plans (whether or not qualified), in tax-sheltered annuities or to self-employed individuals who are participants in an "H.R. 10" plan.

The deductible amount is limited to 10 percent of the employee's compensation for the taxable year. Furthermore, the deductible amount is subject to a dollar limitation which depends upon the nature of the contribution. In the case of voluntary contributions, the deductible amount may not exceed $1,000; in the case of mandatory contributions, the deductible limitation is $100. Thus, for example, if an employee made mandatory contributions of $200 and voluntary contributions of $1,100 for a taxable year, the deduction would be limited to $1,000 (the deduction would be allowed first for the mandatory contributions (up to $100) and the balance of the deduction would be allowed for the voluntary contributions up to a total of $1,000). The reduced limitation with respect to mandatory contributions makes the benefits of the provision available to participants in existing or new plans with mandatory contributions, but does not encourage the shifting of the burden of providing a substantial portion of total benefits under the plan from the employer to the employee.

Proposals have been made in the Congress to change the IRA rules to allow an employee participating in a qualified plan to make a deductible IRA contribution equal to the difference between the employer contributions for his or her benefit and the IRA deduction limitation under current law. Although such proposals could result in a more precise application of the overall IRA limitations, they would

necessarily result in substantial complexity and administrative problems for employers, employees, and the Internal Revenue Service. The committee believes that the new IRA rules will achieve substantial equity for most employees. Moreover, the provision insures that deductions will be available on a nondiscriminatory basis, whereas nondiscrimination cannot be achieved within the context of the existing IRA limitations.

Under the committee amendment an individual is entitled to a single deduction limitation for a taxable year, not to a limitation with respect to each employer. For example, an individual who makes voluntary contributions of $1,000 each to qualified retirement plans maintained by two employers is entitled to a total deduction of $1,000.

Under current law, an IRA deduction for a taxable year is available for contributions to an IRA made during that year or not later than 45 days after the end of the taxable year. In order to be deductible under the provision, contributions to either an IRA or the employer's plan must be made by the employee within the period generally allowed for deductible IRA contributions with respect to the taxable year.

Employee contributions made either to an IRA or to the employer's plan will generally be treated as a contribution made by the employer. This means, for example, that the employee contributions, when combined with contributions or benefits provided directly by the employer, may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Similarly, these employee contributions are treated as employer contributions for purposes of benefit and contribution limits under qualified plans and, where applicable, the rules for defined benefit plans of subchapter S corporations. This would apply even if an employee contribution is within the deduction limits but is not deductible by the employee, such as could occur in the case of an individual who makes contributions to plans maintained by two different employers. Employee contributions are not treated as employer contributions for purposes of determining the employer's deduction for its own contributions to the plan or for purposes of applying the vesting and benefit accrual rules under the Code. For instance, the Code does not require that contributions or benefits provided directly by the employer be fully and immediately vested in all cases, but employees contributions deductible under the committee amendment would be nonforfeitable at all times.

Contributions made to an IRA by an employee participating in an employer's plan will be deductible under the committee amendment only if the funds are transferred to the IRA from the employer. This can occur, for example, by means of the employer withholding funds from employees' compensation and paying the funds over to an IRA or by the employee transferring funds to the employer for retransfer to the IRA. An employer would not be able to hold funds for more than a reasonable period of time before transferring them to the IRA. At the option of the employer, the employee could be limited to a choice of one or a few IRAs, or the employee might be allowed to choose whatever IRA he or she wishes. However, funds could not be transferred to an IRA which is a fixed premium annuity or endowment contract. Funds must be transferred by or through the employer

in order to permit appropriate recordkeeping and verification to determine that the funds, which are treated as employer contributions, do not result in prohibited discrimination.

The availability of distributions of amounts contributed to an IRA would be subject to the rules generally applicable to IRAs. That is, distributions must be made or must commence by age 70½ and generally cannot be made prior to age 59½, death, or disability without the payment of a 10 percent penalty for a premature distribution. Distributions would be taxed on the same basis as other distributions from IRAs.

In the case of deductible contributions to a qualified defined benefit pension plan or money purchase pension plan, distributions attributable to deductible employee contributions would be subject to the rules generally applicable to distributions of employer contributions from such plans. In the case of profit-sharing plans and stock bonus plans, amounts attributable to deductible contributions could be distributed only in the event of death, disability, retirement, or other separation from service, or the occurrence of a hardship. Distributions for hardship would be limited to the amount reasonably necessary to meet the hardship. Distributions would not be allowed merely because of the passage of a period of time, such as a period of participation or a period of accumulation of deductible contributions.

Employee contributions are deductible under the committee amendment only if the employee designates to the employer that the contributions are to be treated as deductible contributions. The employer must report to the Internal Revenue Service the amount of contributions designated by each employee as deductible. Regulations will be prescribed to implement the time and manner for employee designations and employer reporting of those designations.

For withholding purposes, employee contributions within the deductible limitations (as applied to compensation from the employer) would be subject to the rule prescribed under current law with respect to amounts contributed to IRAs generally. That is, withholding would not be required if, at the time of payment of compensation, it is reasonable to believe that the employee will be entitled to a deduction under the committee's provision.

Effective date

This provision is effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $320 million in 1979, $392 million in 1980, and $564 million in 1983. Budget receipts will be reduced by $144 million in fiscal year 1979, $352 million in fiscal year 1980, and $536 million in fiscal year 1983.

2. Simplified pension plans (sec. 152 of the bill and secs. 219, 401, 404, and 408 of the Code)

Present law

Under present law, a trust forming a part of a qualified pension, profit-sharing, or stock bonus plan is exempt from tax, employer contributions to the plan are deductible (within limits) in the year for

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which they are paid, employees generally are not taxed on benefits under the plan until the benefits are distributed or made available to them, 10-year forward income averaging and tax-free rollover treatment applies to lump sum distributions from a qualified plan, and special estate and gift tax exclusions are provided. Qualified plans are required to report financial and other information to plan participants and the Federal Government annually, and are required to provide plan participants with a summary plan description. Also, present law provides Federal fiduciary standards and self-dealing prohibitions for qualified plans. Qualified plans are not permitted to discriminate in favor of employees who are officers, shareholders, or highly compensated.

Present law also provides for IRAs (individual retirement accounts, individual retirement annuities, and individual retirement bonds) under which deductible contributions are limited to the lesser of 15 percent of earned income or $1,500 ($1,750 in the case of spousal IRAs). Employers may establish and maintain employer-sponsored individual retirement accounts or annuities for employees. IRAs are tax-exempt and amounts held in an IRA owned by an individual are generally not taxed to him or her until they are distributed. Reporting requirements with respect to IRAs are considerably less burdensome than those that apply to qualified pension plans. Fiduciary standards and self-dealing prohibitions are generally more easily complied with under an employer-sponsored IRA than under a qualified plan.

Reasons for change

The committee is aware that many qualified pension plans have been terminated in the recent past due, in part, to the complex and burdensome rules they are required to satisfy. The committee believes that these rules have also had the effect of retarding the introduction of new pension plans. The committee is concerned that, because of the expense and effort required to comply with present rules for tax qualified plans, many employees, particularly the employees of small businesses, will not earn employer-provided retirement benefits.

The committee understands that many of the complex rules of the pension law are provided to give employers flexibility to tailor retirement plans to the particular needs of their businesses. Accordingly, the committee believes that where an employer does not require this flexibility, more simplicity can be obtained by using IRAs instead of a pension plan.

Explanation of provisions

Employee deduction.—If an employee establishes and maintains an individual retirement account or an individual retirement annuity which meets the requirements of the bill, the limitation on deductions for contributions to the account is increased to the lesser of $7,500 or 15 percent of the employee's earned income for amounts contributed by his or her employer to the account or annuity. The limits on employee contributions to an account or annuity are not changed by the bill. For example, if the employer contribution to an employee's account is less than the usual limit on deductible contributions by the employee for a year, the employee could make additional contributions that year to make up the difference. On the other hand, the employee could not make additional deductible contributions to the account for a

year in which the employer contributions exceed the usual limits. In the case of an employee who is an officer or shareholder, or in the case of an owner-employee, the deduction limit is reduced if Social Security taxes are treated as employer contributions. (See additional requirements, below.)

The employee's deduction for amounts contributed by his or her employer to an individual retirement account or individual retirement annuity would be allowed even though the employee is an active participant in a qualified plan, a governmental plan, or a tax-sheltered annuity. However, make-up contributions would not be allowed.

Additional requirements.—Under the bill, the expanded deduction limits apply to an employee's individual retirement account or annuity only if employer contributions to it are made under a written formula followed by the employer and if the account or annuity is maintained solely by the employee. The formula is required to provide nondiscriminatory contributions for a calendar year for each employee who has attained age 25 and has performed service for the employer during any part of 3 of the immediately preceding 5 calendar years. The employer contributions provided under the formula must not discriminate in favor of any employee who is an officer, shareholder, or highly compensated. However, for purposes of testing whether the employer's contributions benefit the requisite employees, employees covered by a collective bargaining agreement and nonresident aliens may be excluded from consideration if those employees could be excluded from consideration under similar rules applicable to qualified pension plans.

Under the bill, employer contributions are generally considered to be discriminatory unless they bear a uniform relationship to the first $100,000 of each employee's total compensation. The employer's formula may, however, provide that employer contributions for each employee are reduced by the amount of the employer's share of Social Security tax. In the case of contributions on behalf of a sole proprietor or a partner who is an owner-employee (within the meaning of the H.R. 10 plan rules), the reduction for an owner-employee is the amount of self-employment tax imposed on that individual. In any case, the employer's formula must specify the method for allocating contributions to each covered employee.

Other IRA rules.—The bill makes no change in the present IRA rules relating to distributions, early or late withdrawals, loans, or self-dealing.

Reporting requirement.—The bill authorizes the Secretary to require such reports as may be required to carry out the purposes of the provisions. The committee expects that these requirements will be minimal.

Effective date

The amendment applies for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $15 million in 1979, $25 million in 1980, and $55 million in 1983. Budget receipts will be reduced by $6 million in fiscal year 1979, $18 million in fiscal year 1980, and $49 million in fiscal year 1983.

3. Amendment to ERISA limitation on benefits for participants in certain collectively bargained plans (sec. 153 of the bill and sec. 415 of the Code)

Present law

Under present law, the annual benefit expressed as a straight life annuity for a participant under a defined benefit pension plan is not permitted to exceed the lesser of $75,000 (adjusted for cost of living increases) or 100 percent of the participant's average compensation for his highest paid three consecutive years of participation. In the case of a plan participant with fewer than 10 years of service, this limitation is reduced by one-tenth for each year of service less than ten.

Reasons for change

The committee has concluded that generally the 100 percent of compensation limitation is appropriate for defined benefit pension plans which provide retirement income to replace wages previously earned during working years. In situations involving rank-and-file participants in certain collectively bargained plans which do not base benefits on compensation, however, the committee believes that the 100 percent of compensation limitation has proved too restrictive.

Explanation of provision

In the case of certain participants in certain collectively bargained defined benefit pension plans, the bill would remove the present law requirement that annual benefits under a defined benefit pension plan are limited to 100 percent of a plan participant's average compensation for his or her highest 3 consecutive years of participation. The bill would not apply to a participant whose compensation for each of any 3 of his or her latest 10 years of plan participation is more than the average compensation of all plan participants for each of the same 3 years. Also, the bill would not apply to a participant who is covered by another plan maintained by one or more of the employers maintaining the collectively bargained plan. The bill would apply only in the case of a plan (1) which is maintained pursuant to a collective bargaining agreement, (2) which covers at least 100 employees, (3) which computes retirement benefits by multiplying a uniform amount by the number of the participant's years of service, (4) which provides for full vesting after a participant has completed 4 years of service, and (5) which provides for employee participation after an employee has completed not more than a 60-day period of service. If the special rule added by the amendment applies to a participant, the dollar limitation ($75,000, adjusted for cost-of-living) is reduced by half.

Effective date

The amendment applies for years beginning after December 31, 1978.

Revenue effect

This provision will result in reduction of budget receipts of less than $5 million annually.

4. Tax-sheltered annuities in mutual funds (sec. 154 of the bill and sec. 403(b)(7) of the Code)

Present law

Under present law, within limits, amounts contributed by a tax-exempt charitable organization or an educational institution to purchase annuities (tax-sheltered annuities) or the stock of a regulated investment company (a mutual fund or a closed-end investment company) for an employee are generally excluded from the employee's income.

The income tax treatment provided for income and gains on the reserves of a life insurance company for a tax-sheltered annuity contract which is purchased to provide retirement benefits is the same as the treatment provided for annuity contracts held by tax-qualified pension plans and individual retirement annuities. This treatment is generally considered more favorable to the company than the tax treatment provided for other annuity contracts.

In the case of amounts contributed for the purchase of stock of a regulated investment company, present law requires that the stock must be used to provide a retirement benefit.

Reasons for change

Although present law restricts the favorable insurance company tax treatment of tax-sheltered annuities to retirement annuities, State law generally requires that the owner of an annuity contract be able to obtain the cash surrender value of the contract if the contract is surrendered before annuity payments begin. Consequently, an employee who owns a tax-sheltered annuity contract may be able to surrender the contract before retirement and use the proceeds for purposes other than retirement.

In the case of a regulated investment company, proposed Treasury regulations require that the stock is not to be distributed before the employee attains age 65 unless the employee becomes disabled or dies. Under the proposed regulations, the stock may be distributed after an employee has separated from the service of the employer only if the employee has attained age 55.

The committee believes that the more restrictive rule for distributions of stock of a regulated investment company has imposed an undesirable competitive disadvantage on regulated investment companies.

Explanation of provisions

The bill permits stock of a regulated investment company to qualify under the tax-sheltered annuity rules if the stock cannot be distributed before the employee retires, dies, separates from service, becomes disabled, attains age 59½, or encounters financial hardship, such as unusual medical expenses.

Effective date

The amendment applies for taxable years beginning after December 31, 1978.

Revenue effect

This provision will result in reduction of budget receipts of less than $5 million annually.

5. Pension plan reserve treatment for annuity contracts issued under State and local governmental pension plans (sec. 155 of the bill and sec. 805(d) of the Code)

Present law

Under present law, favorable income tax treatment is accorded to a life insurance company with respect to the portion of its life insurance reserves allocable to annuity contracts entered into with trusts under tax-qualified pension plans. This favorable treatment does not apply to annuity contracts issued to State and local governments in connection with their unfunded deferred compensation plans or to annuity contracts issued to trusts under State and local retirement plans which are not tax-qualified.

Reasons for change

Because State and local governments are tax-exempt, income on assets held by them and used to pay pension liabilities is not subject to tax. However, income on assets held by a life insurance company's life and allocable to annuity contracts issued to State and local governments to pay pension liabilities is generally taxable, This puts insurance companies which offer annuity contracts at a competitive disadvantage when compared with sellers of other types of investments used by State and local governments for the purpose of paying pension benefits.

Explanation of provision

Under the provision, the portion of a life insurance company's life insurance reserves which is allocable to annuity contracts entered into (1) with trusts under State and local pension plans, or (2) with State and local governments for the purpose of paying pension benefits under unfunded plans which defer the compensation of participants to taxable years after it is earned, is accorded the same favorable tax treatment accorded reserves allocable to annuity contracts entered into with trusts under tax-qualified pension plans.

The House bill contains no comparable provision.

Effective date

The amendment applies for taxable years beginning after December 31, 1978.

Revenue effect

This provision will result in reduction of budget receipts of less than $5 million annually.

H. Other Individual Income Tax Provisions

1. Uniformed Services Health Professions Scholarship Programs (sec. 161 of the bill)

Present law

Under present law, Public Law 95–171, participants in the Uniformed Services Health Professions Scholarship Programs (including the Armed Forces and Public Health Services programs) entering before 1979 may exclude from their income amounts received under these programs through 1982.

Reason for change

In view of Congressional and Administration concern regarding the need for these health professions scholarships for the uniformed services, the committee believes that these scholarships should continue to be excluded from gross income pending a thorough review of the appropriate tax treatment of these grants in view of the overall national policy toward the military and other uniformed service health professions programs.

Explanation of provision

This provision extends the exclusion provided under present law to scholarships for students entering the programs in 1979 and applies through 1983. This one-year extension generally covers program participants in the 1978 fall freshmen medical school classes for their four years of training.

There is no comparable provision in the House bill.

Effective date

This provision is effective with respect to students entering programs in 1979.

Revenue effect

This provision reduces budget receipts by less than $5 million annually.

2. Cancellation of certain student loans (sec. 162 of the bill and sec. 61 of the Code)

Present law

Gross income means all income, from whatever source derived, including income from discharge of indebtedness, unless otherwise provided by law (sec. 61). However, subject to certain limitations, gross income does not include any amount received as a scholarship at an educational institution or as a fellowship grant (sec. 117(a)). An amount paid to an individual to enable him or her to pursue studies or research does not qualify as a scholarship or fellowship grant if such amount represents compensation for past, present, or future employment services or if such studies or research are primarily for the benefit of the grantor (Regs. § 1.117–4(c)).

Under certain student loan programs established by the United States and State and local governments, all or a portion of the loan indebtedness may be discharged if the student performs certain services for a period of time in a certain geographical area pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled on a situation in which a State medical education loan scholarship program provided that portions of the loan indebtedness were discharged on the condition that the recipient practice medicine in a rural area of the State. The Service determined that amounts received from such a loan program were included in the gross income of the recipient to the extent that repayment of a portion of the loan is no longer required (Rev. Rul. 73–256, 1973–1 C.B. 56). On November 4, 1974, the Service determined that this ruling would be applied only to loans made after June 11, 1973, the date of the ruling explained above. (Rev. Rul. 74–540, 1974–2 C.B. 38).

Section 2117 of the Tax Reform Act of 1976 (P.L. 94–455) provided that in the case of loans forgiven prior to January 1, 1979, no amount was to be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs. The exclusion applies to a discharge of indebtedness if the discharge was pursuant to a provision of the loan agreement under which all or part of the indebtedness would be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. The amendment made by the 1976 Act applies to student loans made to an individual to assist him in attending an educational institution only if the loan was made by the United States or an instrumentality or agency thereof or by a State or local government either directly or pursuant to an agreement with an educational institution.

Reasons for change

Many States and cities have experienced difficulty in attracting doctors, nurses, and teachers to serve certain areas, including both rural communities and low-income urban areas. A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. The committee agrees with the proponents of these programs that the loan cancellation is not primarily for the benefit of the grantor, as the Service ruled in 1973, but for the benefit of the entire community. The committee believes that the exclusion from income of the amount of indebtedness discharged in exchange for these services would promote the purpose of the programs.

Explanation of provision

The provision extends to loans forgiven prior to January 1, 1983, the exclusion from income provided by the Tax Reform Act of 1976 with respect to cancellation of certain student loans. Accordingly, no amount shall be included in gross income by reason of the discharge of all or part of a student loan of the type described in section 2117 of the 1976 Act if the loan is forgiven prior to January 1, 1983.

There is no comparable provision in the House bill.

Effective date

The amendment applies with respect to loans forgiven prior to January 1, 1983.

Revenue effect

This provision will result in reduction of budget receipts of less than $5 million annually.

3. Employer educational assistance programs (sec. 163 of the bill and new sec. 124 of the Code)

Present law

Under present law, there is no provision for a specific exclusion from an individual's income for educational assistance provided by an employer. Thus, a determination as to whether an individual is required to include in income money or benefits furnished to assist him in his education generally is governed by sections 61 and 117 of the Code.

Section 61 provides that unless otherwise excluded by law gross income means all income from whatever source derived including, but not limited to, compensation for services. Under section 117, subject to certain qualifications, amounts received as scholarships at educational institutions and amounts received as fellowship grants are excluded from gross income.[1] The exclusion also covers incidental amounts received to cover expenses for travel, research, clerical help, and equipment when they are expended for these purposes.

The exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient.[2]

Under present law (Reg. § 1.162–5), educational expenditures made by an individual for his own education generally are deductible if they are for education that (1) maintains or improves skills required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. These types of education are commonly called "job-related education." However, no deduction is allowed for expenditures for education required of the individual in order to meet the minimum educational requirements for employment qualification in the individual's employment or other trade or business or for expenditures for education which is part of a program of study which will qualify the individual in a new trade or business. Such expenses may not be deducted even if the education maintains or improves skills required by the individual in the individual's employment or other trade or business or meets the express requirements of the individual's employer or applicable law or regulations. Nondeductible educational expenditures are personal expenses of the employee. Similarly, expenses which are incurred by an individual for recreation and which are not connected with a trade or business or the production of income, such as taking courses in connection with a hobby, are personal expenses of the individual and are not deductible. Thus, unless the educational expenses are deductible to the individual under the above rules, an employee ordinarily will have income which is not offset by deductions in the following situations:

(1) the employee is reimbursed for educational expenses by the employer;

(2) the employee's educational expenses are paid directly by the employer; or

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[1] To some extent, qualifications differ for individuals who are candidates for degrees and individuals who are not degree candidates. A degree candidate cannot exclude any amount to the extent it represents compensation for teaching, research, or other part-time services which the individual is required to render in order to obtain the grant unless such services are required of all candidates for a particular degree as a condition for receiving the degree.

In the case of a non-degree candidate, the exclusion is available only for up to $300 per month for no more than 36 months and then only if the grantor of the scholarship is a qualified governmental unit, charity, or international organization.

[2] *Bingler* v. *Johnson*, 394 U.S. 741 (1969).

(3) the employer furnishes educational services directly to the employee.

An employer ordinarily can deduct amounts paid or incurred to provide educational assistance to employees because such amounts are treated as compensation under section 61.[3] However, such amounts may be nondeductible in some cases, for example, either as excessive compensation or as dividends, if the benefitted employees are shareholders.

Generally, unless specifically excluded by statute, all remuneration paid to employees, regardless of the form in which paid, constitutes wages subject to withholding of income and employment taxes. Remuneration is not necessarily excluded from the definition of employment tax wages for purposes of employment taxes and income tax withholding simply because it is excludible from gross income under some other section of the Code. However, Treasury regulations provide that certain advances and reimbursements paid to employees for ordinary and necessary business expenses are excluded from the definition of wages for withholding and employment tax purposes. Pursuant to these regulations, the Internal Revenue Service has ruled that educational expenses paid on behalf of, or reimbursed to, an employee for courses which maintain or improve skills required in employment, or meet express requirements of an employer as a condition to retaining employment, that is, job-related educational expenses, are excludable from the wages of the employee for purposes of employment taxes and income tax withholding. If the courses do not satisfy these tests, their cost is considered a personal expense of the employee and the advance or reimbursement is includible in wages and subject to employment taxes and withholding.[4]

Reasons for change

The committee believes that the treatment of employer-provided educational assistance under present law occasionally gives rise to inequitable administration, adds to the complexity of the tax system, and can act as a disincentive to continuing education, particularly among those at the lower end of the economic scale.

Because ambiguities exist in the "improve or maintain skills" test imposed under present law, the taxability of educational assistance programs of particular employers necessarily depends on IRS agents' case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs.

The "job-related" distinction is often both ambiguous and restrictive. For example, if a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experi-

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[3] In situations where an employer acquires items with a useful life in excess of one year and uses them for the direct furnishing of educational assistance to employees, the cost would have to be recovered through deductions for depreciation over the useful lives of such items. In other situations, the deductions would normally be allowed when the amount is paid or incurred (depending on the employer's method of accounting).

[4] See Treas. Reg. §§ 31.3121(a)-1(h), 31.3306(b)-1(h), and 31.3401(a)-1(b)(2); Rev. Ruls. 78-184, 1978-20 I.R.B. 19; 76-62, 1976-1 C.B. 12; 76-71, 1976-1 C.B. 308; and 76-352, 1976-2 C.B. 37.

ence, the value of the training may be taxable. This may discourage self-improvement. If a typist, for example, receives training to be a secretary, or if a secretary receives training in a paralegal program, it might be considered not job-related. Also, if a clerical employee receives computer training, it may be treated as not job-related, even though the employee's job may require computer skills in the future because of normal advances in business technology.

However, the higher the level of job held by an employee, the greater the variety courses or training likely to qualify as related to the employee's job. The committee believes that the unfairness of this anomalous result should be eliminated.

The committee also intends to reduce to the complexity of present law in this area. Not only must the Internal Revenue Service use valuable personnel time in making determinations of taxability, but employees and employers also must justify their positions. The employer also must determine whether income tax withholding and employment taxes apply to reimbursement.

More serious even than the potential inequities of administration and the complexities of the tax law is the disincentive to upward mobility. Although most citizens recognize the need to provide greater access to educational and economic opportunity to those who have had limited access in the past, the tax law presently requires out-of-pocket tax payments for employer-provided educational assistance from those least able to pay, even though they receive only services, not an increased paycheck.

Therefore, the committee provides an exclusion for employer-provided educational assistance. To avoid abuse of this expanded tax-free treatment of educational assistance, the bill limits the exclusion to benefits provided to employees and provides antidiscrimination rules.

Explanation of provision

General

The provision excludes from an employee's gross income amounts paid for expenses incurred by the employer for educational assistance to the employee if such amounts are paid or such expenses are incurred pursuant to a program which meets certain requirements. In the case of education paid for, or furnished by, an individual's employer under such a program, the provision eliminates the need to distinguish job-related educational expenses from personal educational expenses for income tax purposes.[5]

Excludible benefits

The educational benefits which may be excluded from income are those furnished by an employer only to employees. The types of educational assistance which may be furnished are not restricted. The employer may provide educational assistance to the employee directly or the employer may reimburse the employee for the latter's expenses. Under the bill, an employee can exclude from income tuition, fees, and similar payments, as well as the cost of books, supplies, and equipment paid for, or provided by, his employer; however, the em-

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[5] However, such a distinction still would have to be made in situations where the education is not excluded under this provision.

ployee cannot exclude tools or supplies which the employer provides and which the employee may retain after completion of the course of instruction. Meals, lodging, or transportation also may not be excluded under this section. There is no restriction as to who may furnish the educational assistance. Such assistance may be furnished by an educational institution or any other party. Also, the employer, alone or in conjunction with other employers, may furnish the education directly to the employees. The education which may be furnished is not limited to job-related courses nor to courses which are part of a degree program. However, the exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, except where the education provided involves the business of the employer.

For a program to qualify under this provision, the employees must not be able to choose taxable benefits in lieu of the educational benefits.

A taxpayer may not claim any deducation, for example, a business expense deduction, nor may he claim any credit with respect to any amount which is excluded from his income under this provision. Thus, no double tax benefit can be obtained.

An employer educational assistance program is not required to be funded nor to be approved in advance by the Internal Revenue Service.

Nondiscrimination requirements

In order to be a qualified program, an educational assistance program also must meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment. The bill requires that a program must benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, self-employed individuals, highly compensated, or their dependents. The program must be available to a broad class of employees rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that educational assistance benefits were the subject of good faith bargaining between the unit and the employer or employers offering the program.

The bill specifically provides that a program shall not be considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining the availability of benefits.

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

Operation

Under the bill, the exclusion does not apply if the program discriminates in favor of certain employees. A program is discriminatory if more than 5 percent of the benefits can be paid to shareholders, officers, highly compensated employees, self-employed individuals, or dependents of any of these groups.

Special rules

An individual who qualifies as an employee within the definition in section 401(c)(1) of the Code is also an employee for purposes of these provisions. Thus, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

For determining stock ownership in corporations, the bill adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The bill also provides that amounts excluded from income as educational assistance are not to be treated as wages subject to withholding of income nor as wages subject to employment taxes.

There is no comparable provision in the House bill.

Effective date

The bill applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $23 million in 1979, $29 million in 1980, and $40 million in 1983. Budget receipts will be reduced by $18 million in fiscal year 1979, $28 million in fiscal year 1980, and $39 million in fiscal year 1983.

4. Tax counseling for the elderly (Sec. 164 of the bill)

Present law

Present law provides a number of specific tax benefits for elderly or retired individuals; however, it contains no provision dealing with tax counseling for the elderly. The Internal Revenue Service has, however, established a Volunteer Income Tax Assistance (VITA) program which provides individual taxpayer assistance through the use of Internal Revenue Service-trained volunteers.

Reasons for change

Preparation of a tax return is frequently a difficult task for the elderly. Upon reaching retirement age, taxpayers are often confronted with new provisions and complex forms. They often must complete a tax credit for the elderly schedule or a retirement income credit schedule, determine the taxable portion of retirement annuities, or compute the taxable gain when they sell their residences. For an untrained elderly individual, who has perhaps had no experience with the preparation of tax returns other than the short form 1040A, this change in circumstances may result in overpayment of tax. Alterna-

tively, elderly taxpayers may have to rely upon expensive professional taxpayer services.

The committee believes that these problems would be mitigated if the Internal Revenue Service were to expand substantially its tax counseling service particularly tailored to the needs of the elderly. The committee believes that the needs of the elderly in this area are not being adequately met because of the limited scope of the VITA program. Accordingly, the bill authorizes the Internal Revenue Service to enter into arrangements with private or public nonprofit institutions pursuant to which the IRS will furnish the training and technical assistance necessary to enable these nonprofit institutions to establish tax counseling programs for the elderly.

Explanation of provision

The bill authorizes the Secretary of the Treasury, through the Internal Revenue Service, to enter into training and technical assistance agreements with private or public nonprofit agencies and organizations to prepare volunteers to provide tax counseling assistance for elderly individuals in the preparation of their Federal income tax returns. An "elderly individual" is defined as a person who has reached the age of 60 as of the close of a taxable year.

Under the bill, the Service is authorized to provide reimbursement to volunteers for transportation, meals, and other expenses incurred by them in training or providing counseling assistance. The amounts received by the volunteer as reimbursement for these expenses are to be exempt from income and social security taxes, except to the extent that a charitable contribution or other deduction is claimed for these expenses. The Secretary is authorized to provide the volunteers with preferential access to Internal Revenue Service taxpayer service representatives and make available technical information and material needed for their use.

Additionally, the bill provides that, from time to time, the IRS is to direct the attention of elderly individuals to tax measures of particular interest and application to the elderly, such as the tax credit for the elderly (under sec. 37 of the Code) and the provision reducing the tax on the capital gain on the sale of a residence for those age 65 and over (sec. 121 of the Code).

The bill authorizes to be appropriated to carry out the intent of this provision the amount of $2.5 million for fiscal year 1979 and $3.5 million for fiscal year 1980.

Effective date

This provision is to be effective on the date of enactment of the bill.

Revenue effect

It is estimated that enactment of this legislation will have a negligible effect on Federal budget receipts.

5. Study by the Treasury Department of simplifying the filing of Federal individual income tax returns (Sec. 165 of the bill)

Present law

Present law contains no provision requiring a specific study or report on tax simplification by the Treasury Department. However,

section 507 of the Tax Reform Act of 1976 (P.L. 94–455) required the Joint Committee on Taxation to conduct a study on simplifying the tax law.[1]

Reasons for change

The committee believes that certain provisions of the Internal Revenue Code and certain filing procedures are excessively complex and create difficulty for taxpayers in filing accurate tax returns. There are also provisions where complexity of the rules makes determination of a taxpayer's actual liability difficult.

Explanation of provision

The bill directs the Treasury Department to study methods by which the process of filing Federal income tax returns by individuals could be made simpler. The study will include (1) the simplification of Federal income tax provisions and forms relating to: low income, disabled, and retired taxpayers; the taxation of scholarship and fellowship grants (especially as they apply to interns and resident physicians); the sale or exchange of residences; income averaging; and cases involving divorced individuals and the payment of alimony and child support; (2) means for eliminating the so-called "marriage penalty" in the case of married taxpayers, including the feasibility of using only the Schedule X tax rate schedule (now for single taxpayers) for all taxpayers; (3) extension of the original due date for the filing of returns by individuals 65 years of age or older to June 15; and (4) the feasibility of allowing individuals 65 years of age or older to make scheduled appointments for assistance in filing their returns.

The bill requires the Secretary of the Treasury to submit to the Senate Finance Committee and the House Ways and Means Committee a final report of its study, together with its recommendations, no later than 6 months from the date of enactment of this Act.

The House bill does not contain any comparable provision.

Effective date

The provision is effective upon enactment.

Revenue effect

This provision will not have any revenue effect.

I. Partnership Returns

(sec. 171 of the bill and new sec. 6698 of the Code)

Present law

For income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, deduction and credit are allocated among the partners for inclusion in their respective income tax returns.

Partnerships are required to file an annual information return setting forth the partnership income, deductions and credits, names and

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[1] This study was completed and a report entitled "Issues in Simplification of the Income Tax Laws" was issued by the staff of the Joint Committee on Taxation. (September 19, 1977)

addresses of the partners, each partner's distributive share of partnership income, deduction and credit, and certain other information required by the regulations. Neither the partnership nor any partner is subject to a civil penalty for failure to file, or for late filing of, a partnership information return.

Reasons for change

The number of large partnerships (those with over 50 partners) has increased dramatically in recent years. Many of these new large partnerships are complex tax shelter arrangements. In these arrangements, it is often difficult to identify the taxpayers who may ultimately be affected by an adjustment to a partnership item. The entity, for example, may be composed of several tiers, the partners being trusts, corporations, individuals and other partnerships.

The Service has identified instances in which large complex partnerships have failed to file timely and/or complete annual partnership information returns.

Explanation of provisions

The bill enacts a new provision (section 6698 of the Code) that imposes a penalty on the partnership for failure to timely file a complete partnership information return as required by existing Code sections 6031 (relating to the information to be included in a partnership return) and 6072 (relating to the time for filing the partnership return). The penalty is in addition to the criminal penalties imposed by Code section 7203 for willful failure to file a return, supply information, or pay a tax.

The penalty is assessed for each month, or fraction of a month (but not to exceed 5 months), that the partnership return is late or incomplete. The amount of penalty for each month, or fraction of a month, is $50 multiplied by the total number of partners in the partnership during the partnership's taxable year for which the return is due. The penalty is assessed against the partnership. Partners are to be individually liable for the penalty to the extent of their liability for partnership debts generally.

The penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause. The committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. Although these partnerships may technically be required to file partnership returns, the committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance.

The assessment of the penalty is not subject to the deficiency procedures of the Code. Thus, the partnership may not contest the assessment of the penalty in the United States Tax Court, but rather must pay the entire penalty and sue for refund in the U.S. District Court or Court of Claims.

This penalty only applies where a partnership return is required to be filed. Thus, an unincorporated organization which has properly elected (under section 761(a)) not to be treated as a partnership is not

subject to these penalties since no partnership return is required to be filed by that organization.[1]

The House bill contains an identical provision.

Effective date

This provision of the committee amendment is effective for returns for taxable years beginning after December 31, 1978.

Revenue effect

This provision will have no effect on budget receipts.

J. General Stock Ownership Corporations

(Sec. 201 of the bill)

Present law

Under present law, there are no special provisions relating to the establishment of a private corporation for the benefit of the residents of a State.

Reasons for change

The committee believes that many citizens should have a greater ownership stake in the private enterprise system, and that this would lead to better understanding of the system and would encourage individuals to invest in other business enterprises. Also, in the case of individuals now receiving various forms of transfer payments from Federal, State, or local governments, the receipt of dividend income from a General Stock Ownership Corporation (GSOC) would, to some extent, reduce the need for such payments. The committee believes that an experimental program permitting States to form such private corporations for the benefit of their citizens may enable the Congress to study a method of replacing transfer payments with dividend income.

Explanation of provisions

General.—Under the committee bill, a State would be authorized to establish a GSOC for the benefit of its citizens. It is anticipated that the GSOC would be authorized to borrow money to acquire business enterprises. The cash flow from the operation of the business would be used to pay the loan, and the corporate revenues would be distributed to the GSOC shareholders (i.e., the citizens of the State).

Definition of GSOC.—The bill provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. First, the corporation must be chartered by an official act of the State legislature or by a State-wide referendum. Second, the GSOC's corporate charter must provide for the issuance of all authorized shares to eligible individuals provided that at least one share is issued to each eligible individual, and such eligible individual does not elect within one year after the date of issuance not to receive such share, and provides for certain restrictions on the transferability of the share. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of 5 years from issuance,

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[1] This rule applies to an election made under either subdivision (i) or (ii) of Treasury Regulations § 1.761–2(b)(2), relating to the method of electing not to be treated as a partnership.

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(2) death or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, an individual may not acquire more than 9 shares by purchase. Third, the charter must provide that the GSOC is empowered to invest in properties (not including properties acquired by it or for its benefit through the right of eminent domain). Fourth, the GSOC may not be affiliated with any other corporation. Fifth, the GSOC must be organized after December 31, 1978, and before January 1, 1984. An eligible individual is any individual who is a resident of the chartering State as of the date specified in the corporate charter. A State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles.

Election.—A GSOC must make an election to obtain the special statutory treatment provided for by the amendment. The election is effective for the taxable year for which it is made on a timely filed tax return. The manner in which the election is to be made would be determined by regulations. The election once made is irrevocable unless terminated with the consent of the Secretary of the Treasury.

Effect of election.—The effect of the election would be to exempt the corporation from Federal income taxation. Instead, the shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

Treated as a private corporation.—A GSOC would be treated as a private corporation.

Computation of GSOC income.—The GSOC would compute its taxable income in the same manner as a regular corporation with certain modifications. The GSOC would not be eligible for a dividends received deduction nor any tax credits.

Net operating loss deduction.—The shareholders of a GSOC would not be eligible to report any portion of a GSOC net operating loss on their individual income tax return. Instead, the GSOC would be entitled to a 10-year carryover of any net operating losses.

Investment tax credit and recapture of investment tax credit.—Under the bill, shareholders of the GSOC would be entitled to their pro-rata share of the GSOC's investment tax credit. The shareholders would also be personally responsible for any recapture of such investment tax credit. Neither the corporation nor its shareholders would be entitled to the foreign tax credit.

Taxation of shareholders.—Under the bill, each shareholder would include in his gross income his daily prorated portion of the GSOC's taxable income. Such income would be included in the shareholder's gross income for the taxable year in which or with which the GSOC's taxable year ends. The income in the hands of the shareholder would be treated as ordinary income and would not be eligible for either the partial dividend exclusion (sec. 116) or the maximum tax of earned income.

Shareholders would increase the tax basis of shares of stock in the GSOC to the extent they reported income from the GSOC. Distributions from the GSOC out of such previously taxed income would decrease the tax basis of such shares.

Taxation of GSOC distribution.—Under the bill, distributions from a GSOC's taxable income previously taxed to a shareholder would

be treated as a tax-free distribution. Any distribution in excess of such previously taxed income would be taxed in the same manner as a distribution from a regular corporation (sec. 301(c)).

Audit adjustments and amended tax returns.—Any audit adjustment resulting from an Internal Revenue Service determination would be reflected in the GSOC's taxable year in which such adjustment is made (and not the taxable year to which it relates). The amount of such adjustment would be subject to an interest charge in an amount computed as though the income had been taxed to a nonelecting corporation.

Reporting requirements.—Under the bill, a GSOC would be required to file a Federal income tax return and a computer-coded data showing information reported to each of its shareholders. The corporate tax return would be required to meet the same timing requirements as a regular corporation. In addition, a GSOC would be required to give each shareholder a Form 1099. The Form 1099 would report (1) the shareholder's pro rata income for the taxable year, (2) tax-free distributions for the year, (3) the tax treatment of other distributions, and (4) the amount of any investment tax credit and recapture thereof for such year, and (5) any amounts withheld for Federal income tax purposes.

Distribution requirements.—A GSOC would be required to distribute 90 percent of its taxable income to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) would be imposed on the GSOC. The amount of such tax would be allowed as a deduction to the GSOC for the year in which it is paid.

Withholding requirements.—The bill requires the GSOC to withhold an amount equal to 25 percent of every distribution made to its shareholders. The amount of such withholding would be allowed as a refundable credit to the shareholder. The Treasury would be authorized to issue regulations providing a certification procedure for individuals who are nontaxpayers under which they may be exempted from the withholding requirement.

Studies.—It is expected that a study would be made of the effect GSOC's have on competition with regular private corporations. It is also anticipated that a study would be made of the GSOC as a form of full corporate integration.

Taxable year end of GSOC.—The bill requires a GSOC to adopt a taxable year end of October 31. It is anticipated that most GSOC's would elect an October 31 year end. This would enable them to close their books and meet their shareholder reporting requirements by January 31 of the next succeeding year.

Effective date

The provision applies to corporations chartered and organized after December 31, 1978.

Revenue effect

The revenue cost of the proposal is expected to be negligible during the next few years. However, the long-run cost could be substantial.

K. Business Tax Provisions

1. Corporate rate reductions (sec. 301 of the bill and secs. 11, 12, 244(a)(2), 247(a)(2), 511(a), 527(b), 528(b), 802(a), 821, 826(c), 852(b), 857(b), 882, 922(a)(2), 962, 1351(d), 1551, and 1561 of the Code)

Present law

Under present law, corporate income is subject to a normal tax of 20 percent on the first $25,000 of taxable income and 22 percent on taxable income in excess of $25,000. In addition, a surtax of 26 percent is imposed on corporate taxable income in excess of $50,000. This rate structure was enacted temporarily in the Tax Reduction Act of 1975 and has been extended through the end of 1978 in subsequent legislation.

For taxable years ending after December 31, 1978, the normal tax will be 22 percent on all corporate taxable income. In addition, the 26-percent surtax will be imposed on all taxable income in excess of $25,000. Thus, for taxable years ending after December 31, 1978, corporations will pay corporate income tax of 22 percent on the first $25,000 of taxable income and 48 percent on taxable income in excess of $25,000.

Reasons for change

The committee believes that reduction of the corporate tax rates is necessary to reduce unemployment and stimulate economic growth through capital investment. In addition, the committee believes that the reduction in corporate tax rates and the application of graduated rates to corporations will encourage growth in small business and provide tax relief to those companies. Tax relief in the form of rate reductions is especially needed for small companies that are not particularly capital intensive. Of the overall corporate rate cut of $5 billion, about $1 billion goes to corporations with taxable incomes of less than $100,000.

Graduated corporate tax rates also will reduce the abrupt jump in tax rates under present law as taxable income increases above $50,000 under the expiring temporary provisions, and above $25,000 under the permanent provisions in present law. Moreover, application of the graduated rates to corporations should reduce the impact of the tax laws in the selection of a form of organization for operation of a small business. Reduction in the corporate tax rates and application of graduated rates to corporations would reduce the relative importance of the tax laws on this choice. As a result, nontax economic factors will receive greater emphasis in selection of the corporate, partnership, or sole proprietorship form for the operation of a small business.

Explanation of provision

The committee bill repeals the present normal tax and surtax and in their place imposes a five-step tax rate structure on corporate taxable income. Under the committee bill, the following tax rate structure will be applicable after December 31, 1978:

[In percent]

Taxable income	*Tax rate under H.R. 13511*	*Tax rate under present law*
$0 to $25,000	17	20
$25,000 to $50,000	20	22
$50,000 to $75,000	30	48
$75,000 to $100,000	40	48
Over $100,000	46	48

The bill continues the special rules for the tax treatment of mutual savings banks conducting a life insurance business, insurance companies, mutual funds (regulated investment companies), and real estate investment trusts. A number of conforming amendments are made to reflect the repeal of the normal tax and surtax and imposition of a graduated tax on corporations. These rules replace the existing rules restricting multiple surtax exemptions with new rules, similar in intent, to prevent abuse of the graduated rate structure.[1]

The House bill contains identical provisions.

Effective date

The provisions are effective for taxable years beginning after December 31, 1978.

The bill specifically applies the rules for rate changes of fiscal year corporate taxpayers (sec. 21 of the Code) to allow these corporations the benefits of the new corporate rates for that part of their 1978–1979 fiscal year which falls in 1979. Under this provision, fiscal year taxpayers are to compute their tax liability for that year both without regard to these changes and taking these changes into account. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling in 1979.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $5,069 million in 1979, $5,551 million in 1980, and $7,288 million in 1983. Budget receipts will be reduced by $2,281 million in fiscal year 1979, $5,286 million in 1980, and $6,940 million in fiscal year 1983.

The combined effect of extending the present corporate tax rates and the additional revenue effects of enacting the rate structure in this provision will be a reduction in budget receipts of $3,208 million in fiscal year 1979, $7,434 million in 1980, and $9,759 million in 1983.

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[1] For example, under present law, controlled groups (under section 1561) are limited to one $50,000 surtax exemption which is apportioned among the members of the group. In order to conform to the graduated rate schedules, section 1561 is changed to limit a controlled group to a total of only $25,000 of taxable income in each of the rate brackets below the 46-percent bracket. Thus, if there are three members of a controlled group and if no plan for unequal apportionment is adopted, each member will be subject to tax at a rate of 17 percent of its first $8,333 of taxable income, 20 percent of its second $8,333, 30 percent on its third $8,333, 40 percent on its fourth $8,333 and 46 percent on its taxable income in excess of $33,333.

2. Permanent increase and revisions in investment tax credit

a. Permanent extension of 10-percent credit and $100,000 limitation on used property (sec. 311 of the bill, sec. 46(a)(2) of the Code, and sec. 301(c)(2) of the Tax Reduction Act of 1975)

Present law

Present law provides a credit against income tax liability for a taxpayer's investment in certain types of depreciable business assets. The investment credit rate is presently 10 percent of qualified investment. This rate was temporarily increased from 7 percent to 10 percent under the Tax Reduction Act of 1975 and is presently scheduled to return to 7 percent (4 percent for certain public utility property) in 1981.

Present law also limits the availability of the credit for investment in qualified used property to $100,000 each taxable year for any taxpayer. This limitation was temporarily increased from $50,000 to $100,000 under the Tax Reduction Act of 1975 and is scheduled to return to $50,000 in 1981.

Reasons for change

Since its enactment in 1962, the investment tax credit has been an effective incentive to investment in qualified equipment. Statistics on such investment show a positive relationship between the level of investment and the enactment, reenactment, suspension, repeal, or a change in the rate of the credit. Investment has increased when the credit has been made available and decreased when the credit was rescinded. The effectiveness of the credit arises from the fact that it reduces the purchase price of the equipment and in effect increases the net cash flow after taxes to the investor.

The committee believes that the uncertainty as to whether the present temporary 10-percent credit will be extended or made permanent has reduced the effectiveness of the credit. This uncertainty can distort orderly investment programs as businesses rush to place equipment in service before the temporary rate is scheduled to expire.

Explanation of provision

Under the committee's bill, the temporary investment credit rate of 10 percent for all taxpayers, which is scheduled to return to 7 percent (4 percent for utilities) in 1981, is made permanent. The present temporary $100,000 annual limitation on used property eligible for the credit, which is scheduled to return to $50,000 in 1981, is also made permanent.

The House bill contains an identical provision.

Effective date

These amendments will become effective on January 1, 1981, when the temporary extensions are scheduled to expire.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $4,722 million in 1981, $5,974 million in 1982 and $6,723 million in 1983. Budget receipts will be reduced by $2,071 million in fiscal year 1981, $5,201 million in 1982, and $6,283 million in fiscal year 1983.

b. Increase in limitation to 90 percent of tax liability (sec. 312 of the bill and sec. 46(a) of the Code)

Present law

Generally, the amount of the investment credit a taxpayer may apply against his tax liability in any one year cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. Special limitations have been provided for public utility property, under which the 50 percent limit was increased to 100 percent for 1975 and 1976, was 90 percent for 1977, and declines by 10 percentage points in each succeeding year until it returns to the generally applicable 50-percent limit in 1981. Similar increases in the tax liability limitation are available (under the Tax Reform Act of 1976) to railroads and airlines for their investment in transportation property, each of which are allowed to apply their investment credits against 100 percent of tax liability for 1977 and 1978, and the limitation is reduced by 10 percentage points in each subsequent year until it returns to 50 percent in 1983.

Generally, investment credits which are not, because of the tax liability limitation, used in the year earned may be carried back to the preceding three taxable years and carried over to the seven following taxable years. Credits which are not used during these carryback and carryover periods expire, and the taxpayer no longer obtains tax benefits from the credits.

Reasons for change

The present limit on the amount of tax liability that can be offset by the investment credit usually does not create any difficulty for taxpayers. The unusual situations when the limitation prevents taking the credit in full may become a disincentive to investment. These situations may develop in several different conditions. The committee believes that increasing the tax liability limitation will have a beneficial effect on capital formation.

Explanation of provision

The bill would increase the present 50 percent tax liability limitation to 90 percent, to be phased in at an additional 10 percentage points per year beginning with taxable years which end in 1979.[1] As a result, the limitation will be 60 percent for taxable years ending in 1979, 70 percent for 1980, 80 percent for 1981, and 90 percent for 1982 and subsequent years. For example, in taxable years ending in 1980, taxpayers in general will be entitled to use investment credits (including carryover and carryback credits) to offset the first $25,000 of tax liability dollar-for-dollar, and 70 percent of tax liability in excess of $25,000.

Special rules are also provided for railroads, airlines, and certain utilities so that the phase-in of this increased limitation does not reduce the amounts of investment credits these taxpayers may use under the special increased limitations made available to them by present law. For example, present law provides railroads and airlines each with a limitation of up to 80 percent for 1980, when the generally applicable limitations under this bill will be 70 percent. In this situa-

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[1] Certain obsolete provisions are also repealed by this provision. The committee intends that existing law remain unchanged by these amendments.

tion, taxpayers investing in railroad property or in airline property may apply whichever limitation entitles them to use the greater amount of investment credits.

The House bill contains an identical provision.

Effective date

These amendments are effective for taxable years ending after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $287 million in 1979, $629 million in 1980 and $728 million in 1983. Budget receipts will be reduced by $129 million in fiscal year 1979, $441 million in 1980, and $782 million in fiscal year 1983.

c. Investment credit for pollution control facilities (sec. 313 of the bill and sec. 46(c) of the Code)

Present law

In the case of pollution control facilities for which five-year amortization has been elected, the investment credit is allowed for only one-half of the investment which is eligible for this special amortization.

Reasons for change

The increased costs of meeting the capital requirements for pollution control result from general inflation and the increased costs of energy sources. In addition, shifts from oil or gas to coal for fuel requires investment in pollution control equipment not ordinarily necessary with the use of oil or gas. Furthermore, increasing attention to the sources of environmental pollution has lengthened the list of productive activities which are required to install pollution control equipment.

In many cases, installation of the equipment in an existing facility neither increases productive efficiency nor increases the capacity to produce. The costs of pollution control then must be included in product prices, which has inflationary implications and also tends to reduce the rate of return on investment.

The committee also believes that the consequent reduction in the costs of complying with the antipollution regulations will free internally generated funds for investment in equipment which will increase productive capacity and efficiency.

Explanation of provision

The bill relaxes the restriction in present law limiting the amount of investment credit available for pollution control facilities which a taxpayer has elected to amortize over a five-year period. Under the bill, the full investment credit will generally be allowed on pollution control facilities which are amortized over 5 years and which have actual useful lives of at least 5 years. Pollution control facilities which have useful lives of 3 or 4 years will continue to be subject to the present law rule which, in effect, limits the credit to one-third of the full credit.

The House bill contained the same provision except that it, in effect, limited pollution control facilities to one-half of the full credit if financed by tax-exempt industrial development bonds.

Effective date

This amendment will apply to pollution control facilities acquired or constructed after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $14 million in 1979, $49 million in 1980 and $228 million in 1983. Budget receipts will be reduced by $10 million in fiscal year 1979, $34 million in 1980, and $211 million in fiscal year 1983.

d. Investment credit for single purpose agricultural structures (sec. 314 of the bill and sec. 48(a)(1) of the Code)

Present law

Present law provides a credit against income tax liability for a taxpayer's investment in certain types of depreciable business assets. The investment credit rate is presently 10 percent of qualified investment in eligible property.

Eligible property for purposes of the investment tax credit includes tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit is also allowed for other tangible property which is used as an integral part of manufacturing, production, extraction, or in furnishing certain utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Farming is considered a production activity so that such items as fences, drain tiles, paved barnyards and water wells are eligible for the credit even though these items would be considered real property under local law.[1]

Buildings and their structural components generally are not eligible for the investment credit. The Internal Revenue Service has ruled that barns, stables and poultry houses are buildings and are ineligible for the credit.[2] However, certain special purposes structures are not considered ineligible buildings. A special purpose structure which qualifies for the credit is one which houses property used as an integral part of a production activity (such as farming) where the structure is so closely related to the use of such property that it is clearly expected to be replaced when the property it houses is replaced. One indication of this type of structure is that the structure cannot be economically used for any purpose other than that related to the property it houses.[3] Ineligible buildings are also generally considered to include any structure which encloses a space within its walls (and usually covered by a roof) the purpose of which is to provide shelter or working space. Examples of buildings include factory and office buildings, warehouses, and barns (Regs. § 1.48–1(e)(1)).

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[1] Rev. Rul. 66–89, 1966–1 Cum. Bull. 7.
[2] *Ibid.*
[3] Regs. § 1.48–1(e)(1).

In 1971, this committee stated that special purpose structures used in unitary hog-raising systems would be considered special purpose structures which qualify for the investment credit, and would not be considered buildings.[4] However, the Internal Revenue Service considers that eligibility of special purpose farm structures must be approached on a case-by-case basis. For example, in three recent cases the Service contended that structures which are designed and used for poultry-raising and egg-producing activities were not eligible for the investment credit.[5] Although the Service was unsucessful in two of these cases, it is understood that the Service continues to adhere to the position that special purpose poultry-raising and egg-producing structures are not generally eligible for the investment credit.

Greenhouses are structures which provide an environment for the controlled growth of flowers and other plants. These structures also provide working space for persons who care for the flowers and plants within the greenhouse. It is the position of the Internal Revenue Service that greenhouses are buildings and are consequently ineligible for the credit based on the fact that these structures provide working space for persons tending the plants. The Service's position was sustained in two Tax Court cases decided in 1972.[6] However, the Tax Court was overruled in one of these cases on appeal.[7] In this latter case, the Ninth Circuit Court of Appeals found that the workers' activities in the greenhouse were "merely supportive of, and ancillary to" the principal use of the structure of providing an environment for controlled plant growth.

Reasons for change

When the investment tax credit was restored in 1971 it was the intention of the committee, as expressed in its report on the Revenue Act of 1971, to make it clear that the credit as restored was to apply to special purpose agricultural structures. Despite this expression of intent, the Internal Revenue Service has denied the credit to special purpose agricultural structures and enclosures used for raising poultry, livestock, horticultural products or for producing eggs. Taxpayers' litigation to establish their right to these credits is both expensive and troublesome, particularly in cases involving small farmers with limited amounts of eligible property. As a result of this continuing controversy, the committee has decided to specifically provide that these agricultural structures are eligible for the investment credit.

Explanation of provision

This provision makes structures or enclosures used for single purpose food or plant production specifically eligible for the investment tax credit. To be eligible for the credit under the bill, the structure must be both specially designed and used solely for the production of poultry, eggs, livestock, or plants. For example, if a portion of a

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[4] S. Rept. No. 92–437, 92d Cong., 1st Sess. (1971).

[5] *Melvin Satrum*, 62 T.C. 413 (1974), *nonacq.*, 1978–23 Int. Rev. Bull. 7 (June 5, 1978); *Starr Farms, Inc.* v. *U.S.*, 78–1 U.S.T.C. ¶9183 (W.D. Ark. 1977); *Walter Sheffield Poultry Co.*, T.C. Memo 1978–308.

[6] *Sunnyside Nurseries*, 59 T.C. 113 (1972); *Arne Thirup*, 59 T.C. 122 (1972).

[7] *Thirup et al.* v. *Comm.*, 508 F. 2d 918, 75–1 USTC ¶9158 (9th Cir. 1974). This case was followed in *Stuppy, Inc.* v. *United States*, 78–2 U.S.T.C. ¶ 9364 (W.D. Mo. 1978).

greenhouse is used to sell plants (for example, by installation of a check-out stand for customers), the greenhouse will not qualify for the credit. However, the fact that a greenhouse provides working space for those who care for the plants will not make the greenhouse ineligible for the credit. Also, a structure ceases to be a qualifying structure if it is used for a purpose (such as for storage of feed or equipment) which does not qualify it for the investment credit under this or other definitions of qualifying property.

It is intended that this provision be broadly construed to apply to all types of special purpose structures and enclosures used to breed, raise and feed livestock and poultry (including the production of eggs and milk), and for the cultivation of plants. Thus this provision will cover unitary hog, poultry, and cattle-raising systems, milking parlors, and greenhouses used to produce either plants or plant products.

The amendment is not intended to apply to general purpose agricultural structures such as barns and other farm structures which can be adapted to a variety of uses.

In addition, the committee wishes to clarify present law by stating that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or store, but not lighting to illuminate parking areas), false balconies and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, floor coverings which are not an integral part of the floor itself such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor but, instead, has adhesives applied which are designed to ease its removal), carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for pictures of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons, and the like which are attached to walls or suspended from the ceiling, are considered tangible personal property and not structural components. Consequently, under existing law, this property is already eligible for the investment tax credit.

The House bill did not contain a comparable provision.

Effective date

This provision will be effective for taxable years which end on or after August 15, 1971.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $22 million in 1979, $22 million in 1980, and $27 million in 1983. Budget receipts will be reduced by $53 million in fiscal year 1979, $33 million in fiscal year 1980, and $26 million in fiscal year 1983.

e. Investment credit for cooperatives (sec. 315 of the bill and secs. 46(e), 47 (a), and 48 of the Code)

Present law

Under present law, cooperatives are taxed as corporations. However, unlike regular corporations, cooperatives are allowed to deduct certain payments and allocations made to patrons and shareholders (sec. 1382 (b) and (c)). Patrons are those persons with whom or for whom the cooperative does business on a cooperative basis. With certain exceptions, the patrons include the deductible payments and allocations in their taxable income (sec. 1385).

Because of this special treatment, the amount of otherwise allowable investment credit which may be used by a cooperative is limited by a fraction, the numerator of which is the cooperative's taxable income and the denominator of which is the cooperative's taxable income plus the deductible payments made to patrons and shareholders (sec. 46(e)(2)(C). The portion not allowed to the cooperative is not passed through to the patrons.

Reasons for change

Cooperatives make a significant contribution to the American economy, particularly in the agricultural sector. The capital needs of cooperatives to finance expansion and modernization, coupled with the reduced level of investment credit available to these taxpayers, both hinders their growth and reduce the amount of patronage distributions which flow through to patrons. In light of these considerations and because the reductions in the corporate income tax rates (also provided in this bill) are of relatively limited benefit to cooperatives, the committee has decided to liberalize the investment credit for cooperatives.

Explanation of provision

The amendment would allow cooperatives, including both farmers' cooperatives and similar cooperative organizations (as defined in sec. 1381(a)), to claim the investment credit to the same extent it is available for taxpayers in general. The credit would not be reduced to reflect the deduction for patronage dividends under present law.

The cooperative would also be provided an election to pass through all or part of its current year credits to its patrons. The election may be made on a year-by-year basis and must be made by the 15th day of the 9th month following the close of the taxable year. However, once an election is made for a taxable year, it may not be revoked for that year, and the cooperative may not subsequently claim credits it has passed through to its patrons. Credits carried over or carried back by the cooperative to the current year will not be subject to this election and may not be passed through to the patrons.

The initial calculation of the credit would be made at the level of cooperative. (Determination of the eligibility of property for the credit and the amount of credit allowed for property are correspondingly made by the cooperative through applying the relevant rules of sections 46 and 48 (e.g., useful life, qualified investment, progress expenditures).)

The organization would then be permitted to allocate all or part of the credit to its patrons on the basis of the quantity or value of business done with or for such patrons for the taxable year with respect to which the credit arose. The allocation would be made on the same basis as the allocation of patronage dividends to patrons under paragraph (1) of section 1388(a). However, the provisions of the other paragraphs of section 1388(a) would not have to be complied with, nor would the organization be required to make any other distributions to its patrons in order to take advantage of this provision for the allocation of the investment tax credit.

The patron is required to report any credit allocated to him on his income tax return for the first taxable year ending after the payment period for the cooperative's taxable year in which the credit was earned. To the extent a cooperative organization allocates all or part of its investment tax credit to its patrons under this provision, the allocated portion of the credit would be considered part of the credit for the taxable year of the individual patron and will not be considered part of the organization's credit for the year under section 46(a)(1)(B). As a result, for example, the limitations on the use of the credit based on the amount of tax under section 46(a)(3) would be applied separately to each patron and to the organization.

The cooperative organization will generally be considered the taxpayer for the application of other rules relating to the investment credit. For example, if the cooperative makes an early disposition of section 38 property which is subject to investment credit recapture under section 47(a)(1), any recapture of the credit will be made at the level of the organization and no recapture will be required of the patrons. Thus, for purposes of calculating the amounts of recapture, any credit allocated to patrons shall be viewed as a credit which was used by the cooperative. This will be true even if some patrons of the cooperative were unable to use the credit, for example, because of the tax liability limitations in section 46(a)(3). (Similarly, any early disposition by the cooperative organization will not impair the ability of the patrons of the cooperative, who were unable to use the credit, to carry such credit forward to subsequent years.)

If the amount of the credit which the organization is permitted to claim for the taxable year (without reference to the provisions of this section) is reduced as a result of an amended return, audit adjustment, judicial determination, or other similar proceeding, such a reduction will normally be treated like any other adjustment of the organization's tax liability. However, if the amount of the reduction exceeds the amount of the investment credit which was not allocated to patrons (that is, the amount of the credit shown on the return in which the election to allocate the credit was made, reduced by the amount allocated to patrons), the amount of such excess will be treated as an increase in tax of the organization in the same way that a recaptured tax would be treated. For example, assume the organization's timely filed return reported an investment credit of $100, and the organization elects to allocate $60 of the credit to its patrons. Thereafter, an audit of the organization's return determines that the organization incorrectly claimed $55 of credit. The amount of the reduction ($55) exceeds the amount of the credit which was not allocated to patrons ($40) by $15.

Accordingly, the organization will be treated as having an increase of tax of $15 under section 47(a). To the extent of the additional $40 of reduced credit, the cooperative would be treated like any other taxpayer whose claimed investment credit is reduced on audit.

The cooperative must report to the Internal Revenue Service the amount of credit apportioned to each patron for the taxable year using the same system used to report patronage dividends and other taxable distributions for a taxable year as exists under present law.

The House bill did not contain a comparable provision.

The amendment would allow cooperatives, including both farmer's cooperatives and similar cooperative organizations (as defined in section 1381(a)), to claim the investment credit to the same extent it is available for taxpayers in general. The credit would not be reduced to reflect the deduction for patronage dividends under present law.

The cooperative would also be provided an election to pass through all or part of its current year credits to its patrons. This election may be made separately for each taxable year the cooperative has generated investment credits and must be made by the 15th day of the ninth month following the close of the taxable year. Once made for a taxable year, the election is irrevocable and the cooperative may not subsequently claim credits it has passed through to its patrons.

The investment credit rules (sections 46–48) will generally be applied at level of the cooperative. Thus, the determination of qualified investment and useful lives will be made by the cooperative. It will compute the amount of credits for the taxable year and will either apply the credits to its tax liability or apportion some or all of these credits to its patrons. The passed-through credits are apportioned among the patrons on the basis of the quantity or value of business done with or for its patrons for the taxable year and the same basis is used for allocating the passed-through credits as is used for allocating patronage dividends for the taxable year.

The cooperative will report to the Internal Revenue Service the amount of credits apportioned to each patron for the taxable year using the same reporting system as is used for reporting patronage dividends and other distribution taxable to the patron for the taxable year.

The patron to whom investment credits are allocated is required to report these credits on his income tax return for the first taxable year ending after the payment period for the cooperative's taxable year in which the credit was earned. The tax liability (under section 46(a)(3)) and carryback and carryover rules (under section 46(6)) will be applied by the patron to the credits allocated to him by the cooperative.

With respect to any credit passed through to patrons, the investment credit qualification and recapture provisions are to be applied by treating the cooperative as the taxpayer. Thus, the useful life of property will be determined in reference to its useful life in the hands of the cooperative. Further, if there is an early disposition of the property, the recapture rules will be applied as if the cooperative had claimed and used the credit against its tax liability. Thus, for purposes of the recapture provisions (sec. 47), if property for which credit was allocated to patrons is disposed of or otherwise ceases to be section

38 property, the cooperative is considered as having been allowed the credit allocated to the patrons for the taxable year in which the property was placed in service.

Effective date

These amendments apply to taxable years ending after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $33 million in 1979, $34 million in 1980, and $40 million in 1983. Budget receipts will be reduced by $46 million in fiscal year 1979, $33 million in fiscal year 1980, and $39 million in fiscal year 1983.

f. Investment credit for working and breeding horses (sec. 316 of the bill and sec. 48(a)(6) of the Code)

Present law

When the 10-percent investment tax credit was restored in 1971, it was specifically provided for livestock. In order to be eligible, livestock must be used in a trade or business for the production of income and be subject to depreciation with a useful life of three years or more. This legislation also made horses ineligible for the investment credit. The exclusion of horses applies not only to horses used for sporting purposes (such as race horses and show horses) but also to those horses which are held for working and breeding purposes.

Reason for change

The committee has reexamined the basis for its 1971 decision to exclude horses from eligibility for the investment tax credit. It has concluded that working and breeding horses (for example, on ranches and horse farms) should be accorded the same investment credit incentives as productive assets used in other trades and businesses. As a result, the bill provides that working and breeding horses are eligible for the credit.

Explanation of provision

The bill extends the investment tax credit to horses, other than horses held for race or show purposes. Under this provision, horses which are acquired and used for breeding or working purposes (but not to race or show) will be eligible for the credit. Working horses for purposes of this provision are considered to include either riding or draft horses which are not used for racing or show purposes.

The rules concerning "wash sale" rules concerning livestock will also apply to horses eligible for the credit in order to prevent taxpayers from creating a tax shelter of artificial credits by disposing of mature horses with little or no cost or other basis, and then acquiring substantially similar horses with the intent of obtaining the credit for the newly acquired animals.

In determining whether horses acquired by a taxpayer are new or used property for purposes of the credit, the committee intends that horses be treated in a manner consistent with that provided in the Treasury regulations for other types of property. Property is considered new property for purposes of the credit if its original use com-

mences with the taxpayer. The regulations provide that the term "original use" means the first use to which the property is placed, whether or not the use corresponds to the use of the property by the taxpayer. However, where a horse qualifies as a breeding or work animal, it will normally be regarded as new property at the time it is first used for these purposes, that is, at the time its suitability is established by the bearing of a foal or its capability to perform work, assuming it has not been used for other purposes prior to that time. On the other hand, if a mare or stallion has been used for racing or show purposes and later is used for breeding or work purposes, it will not be "new" property when first used for breeding or work purposes. If a mare or stallion that has been used for racing or show purposes is later sold to an unrelated taxpayer and is used to breed racing or show horses, it will also be "used" section 38 property.

Effective date

This amendment is effective for taxable years ending after December 31, 1978, for property placed in service after that date.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $15 million in 1979, $17 million in 1980, and $22 million in 1983. Budget receipts will be reduced by $6 million in fiscal year 1979, $16 million in fiscal year 1980, and $21 million in fiscal year 1983.

g. Additional carryover year for credits expiring in 1977 (sec. 317 of the bill and sec. 46(b) of the Code

Present law

Under present law, the investment tax credit for any year generally cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. (However, section 312 of the bill increases the limitation to 90 percent on a phased-in basis.) If the amount of investment tax credit for any year exceeds the applicable limitation based on the amount of tax liability for that year, the excess is generally an investment credit carryback to each of the 3 preceding taxable years and an investment credit carryover to each of the seven following taxable years and, subject to certain limitations, is included in the amount allowable as a credit for those years (sec. 46(b)). However, pre-1971 investment credits are allowed a 10-year carryover.

Under the 1976 Tax Reform Act, the rules determining which year's investment credits are considered to be used first were modified so that in any year, carryover credits from prior taxable years—beginning with the earliest eligible preceding year—are to be used first in the current year before any credits arising in the current year—or any carryback from future years. If any portion of a credit remains unused after application of the carryback and carryover periods, the unused portion expires and cannot be used subsequently by the taxpayer.

Reasons for change

During 1970–71 and 1974–75 the economy suffered two serious recessions. Nonetheless, in order to remain competitive domestically and internationally, many taxpayers have continued to invest in new plant and equipment in the United States. However, where net operating

losses have been incurred, these losses have often reduced or eliminated the taxable income in the earlier and later years and resulted in unused carryforwards of investment tax credits. The committee is concerned that the expiration of the carryforward period for these credits may adversely affect these taxpayers' investment programs, and thereby impact adversely on the longrun structure of capital formation. To mitigate these problems the committee amendment provides that investment tax credits which would otherwise expire in 1977—that is, investment credits earned in 1967—may be carried forward 1 additional year.

Explanation of provision

The committee provision provides that investment tax credits that may be carried over to the first taxable year ending in 1977, but which would otherwise expire at the end of that year, may be carried over to the next succeeding taxable year (generally the taxable year ending in 1978). This additional 1-year carryforward does not apply to credits that might expire in 1978 or later years, but only to credits which would expire in 1977 and applies only to extend their carryover period for one taxable year.

The House bill did not contain a comparable provision.

Effective date

This amendment is effective on date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

h. Investment credit for manufacturer-lessors of railroad property (sec. 318 of the bill and sec. 36(a)(8) of the Code)

Present law

Under present law, special tax liability limitations apply with respect to the investment tax credit for railroads. Taxpayers with railroad property are allowed, under provisions enacted in the Tax Reform Act of 1976, to take credits up to 100 percent of tax liability for 1977 and 1978 with annual reductions of 10 percentage points thereafter until the limitation returns to 50 percent of tax liability in excess of $25,000 in 1983. Only the operator of a railroad, and not a lessor of railroad property, is eligible for the special increased limitation.

Reason for change

The committee believes that this higher limitation should also apply to taxpayers who manufacture and lease railroad cars. By making this higher limitation available to these taxpayers during the period during which the tax liability limitation is phased-up to 90 percent for all taxpayers, the committee believes that the serious shortage of railroad rolling stock will be alleviated.

Explanation of provision

The committee's bill provides that the tax liability limitation applicable to taxpayers with railroad property would also apply to investment tax credits applicable to railroad rolling stock placed in

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service by a taxpayer who manufactured the rolling stock and leases it out to others. Manufacturer-lessors would be eligible for the increase to the same extent as operators of railroads. Under special rules, the phase-in of the tax liability limitation to 90 percent for all taxpayers is not to reduce the special increased limitation for railroad property. For example, present law provides railroads with a limitation of up to 80 percent for 1980, when the generally applicable limitations under this bill will be 70 percent. In this situation, taxpayers investing in railroad property, including manufacturer-lessors of rolling stock, may apply whichever limitation entitles them to use the greater amount of investment credits.

The House bill did not contain a comparable provision.

Effective date

This amendment is effective for taxable years ending after December 31, 1978 for property placed in service after that date.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $8 million in 1979, $2 million in 1980, and increase them by $2 million in 1983. Budget receipts will be reduced by $4 million in fiscal year 1979, $5 million in fiscal year 1980, and will be increased by $2 million in fiscal year 1983.

i. Transfers to ConRail not treated as dispositions for purposes of the investment credit (sec. 319 of the bill and sec. 47(b) of the Code)

Present law

On April 1, 1976, eleven insolvent midwestern and northeastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress [1] in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under this legislation, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) will receive ConRail stock and "certificates of value" issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization.

In 1976, the Congress also enacted legislation to deal with the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,[2] the transfer of rail properties to ConRail is treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders do not recognize gain or loss

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[1] The facilitating legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93–236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94–210, approved February 5, 1976).

[2] P.L. 94–253, approved March 31, 1976.

on the transfer and ConRail receives a carryover basis in the properties it acquired.

However, this 1976 tax legislation did not deal with investment credit recapture which may arise to the transferor railroads because of the ConRail reorganization. In contrast, present law generally provides an exemption from investment credit recapture where assets are transferred in a tax-free reorganization.

Reasons for change

Since the committee last considered the tax aspects of the ConRail reorganization in 1976, it has noted that a transferor railroad which was required to transfer its rail properties to ConRail may be subject to tax on this transfer because of investment credit recapture, even though present law generally provides an exemption from investment credit recapture where assets are acquired in a tax-free reorganization.

The committee's bill corrects this uncontemplated result arising from the ConRail reorganization.

Explanation of provision

The bill adds an exception to the investment credit recapture rules (sec. 47(b)) so that a transferor railroad will not be subject to additional tax on its transfer of rail properties to ConRail. However, the committee intends that investment credits which are not subject to recapture because of this provision shall be treated as "other benefits" to the same extent that any other tax benefits are so treated for purposes of the special court's determination of compensation to the transferor railroads under sections 303 and 306 of the Regional Rail Reorganization Act of 1973.

The House bill did not contain a comparable provision.

Effective date

This amendment applies to taxable years ending after March 31, 1976.

3. Targeted jobs tax credit (sec. 321 of the bill and secs. 51, 52, and 53 of the Code)

Present law

The Tax Reduction and Simplification Act of 1977 provided a new jobs tax credit for 1977 and 1978. The credit is 50 percent of the increase in each employer's wage base under the Federal Unemployment Tax Act (FUTA) above 102 percent of that wage base in the previous year. The FUTA base for 1977 consisted of wages paid of up to $4,200 per employee.[1] The employer's deduction for wages is reduced by the amount of the credit. Therefore, although the maximum gross credit for each new employee is $2,100, the actual reduction in taxes per employee ranges from $1,806 (for a taxpayer in the 14-percent tax bracket) to $630 (for a taxpayer in the 70-percent bracket).

The total amount of the credit has four limitations: (1) the credit cannot be more than 50 percent of the increase in total wages paid by

[1] For 1978, the FUTA wage base went up to $6,000. In order to make the 1978 wage base comparable with 1977 for purposes of the jobs credit, present law requires that only the first $4,200 of the FUTA wage base for each employee be included in the computation.

the employer for the year above 105 percent of total wages paid by the employer in the previous year, (2) the credit must be no more than 25 percent of the current year's FUTA wages, (3) the credit for a year cannot exceed $100,000, and (4) the credit cannot exceed the taxpayer's tax liability. Credits which exceed tax liability for a year may be carried back for 3 years and carried forward for 7 years.

Although most employers are able to use the returns they file for purposes of complying with FUTA as a basis for claiming the credit, special rules are provided for businesses, such as farms and railroads, not covered under FUTA.[2] Special rules also are provided for computation of the credit by groups of companies under common control, for businesses with employees working abroad, and for businesses affected by acquisitions, dispositions, and other changes in business form. Additional rules are provided for allocating the credit among members of a partnership and of a subchapter S corporation.

Present law (adopted in the 1977 Act) also provides an additional nonincremental credit equal to 10 percent of the first $4,200 of FUTA wages paid to handicapped individuals (including handicapped veterans) who receive vocational rehabilitation. The credit is based on the first $4,200 of wages paid to a handicapped individual whose first FUTA wages from the employer are paid in 1977 or 1978. Only wages paid during the 1-year period beginning when the individual is first paid FUTA wages by the employer are taken into account in computing the 10-percent credit. The credit for handicapped workers cannot be greater than one-fifth of the regular 50-percent new jobs credit which would have been allowable without regard to the $100,000 limitation. However, the special 10-percent credit is not itself subject to any specific dollar limitation.

Reasons for change

The committee believes that the unemployment rate has declined sufficiently so that it is appropriate to focus employment incentives on those individuals who have high unemployment rates, even when the national unemployment rate is low, and on other groups with special employment needs.

The committee, therefore, has decided to let the current new jobs credit expire at the end of 1978. In its place, the committee has designed a provision which should provide an incentive for private employers to hire individuals in six target groups. The groups have been defined on the basis of their low income or because their employment should be encouraged. Included among the targeted individuals are recipients of Supplemental Security Income (SSI) disability payments and gneral assistance, a term which covers a variety of State and local programs for the needy. As a result of increasing employment among these groups, the committee hopes to lower outlays for these programs. Three other groups may have somewhat higher incomes but they have special employment problems: youths of ages 18 through 24, Vietnam veterans, and convicted felons, who are members of eco-

[2] Generally, employers who employ one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pay wages of $1,500 or more during any calendar quarter of the current or preceding calendar year are covered under FUTA.

nomically disadvantaged families. One last group has been added in order to encourage employers to participate in an educational process which the Committee believes is particularly valuable: handicapped individuals who are undergoing vocational rehabilitation.

Explanation of provision

General rules

The bill extends the jobs credit for a three-year period and amends the provisions of the new jobs credit so that a credit is allowed only for hiring members of six target groups. The credit allowed in any taxable year is equal to 50 percent of qualified first-year wages, 33⅓ percent of qualified second-year wages and 25 percent of qualified third-year wages. Qualified first-year wages consist of wages attributable to service rendered by a member of a target group during the one-year period beginning with the day the individual first begins work for the employer. For a vocational rehabilitation referral, however, the period begins the day the individual begins work for the employer on or after the beginning of this individual's vocational rehabilitation plan. Qualified second-year wages consist of the wages attributable to service rendered during the one-year period which begins at the close of the first year described just above, and a similar definition is provided for qualified third-year wages. Thus, the date on which the wages are paid does not determine whether the wages are first-year, second-year, or third-year wages; rather, the wages must be attributed to the period during which the work was performed. With respect to employees in the target groups other than vocational rehabilitation referrals for whom credits currently are being claimed under existing law, qualified wages do not include wages paid to employees who were first hired by the employer before September 26, 1978. However, employees who are hired on or after that date, will be treated, for the purpose of defining first-, second-, and third-year qualified wages, as if they began work for the employer on the first day of the taxable year beginning after December 31, 1978, or, if later, the actual date they began work.

No more than $6,000 of wages during either the first, second or third year of employment may be taken into account with respect to any individual.[1] Thus, the maximum credit per individual is $3,000 in the first year of employment, $2,000 in the second year of employment, and $1,500 in the third year of employment. However, the deduction for wages is reduced by the amount of the credit. Thus, for an employer who hires an eligible employee who earns $6,000 in his first year of em-

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[1] For example, if an employer with a calendar year taxable year hires an eligible employee on September 1, 1979 and pays him $2,500 in that taxable year, the employer is eligible for a credit of 50 percent of the $2,500, or $1,250 in that taxable year. For the next taxable year, the employer also is eligible for a 50-percent credit on the next $3,500 paid to that employee through August 31, 1980. No credit is allowed on any additional wages paid to that employee through August 31, 1980. However, the employer is eligible for the 33⅓ percent credit on any wages paid to the employee beginning September 1, 1980 until the total wages paid to the employee from that date (through August 30, 1981) equal $6,000. In addition, the employer is eligible for the 25 percent credit on any wages paid to the employee beginning September 1, 1981, until the total wages paid to the employee from that date (through August 30, 1982) equal $6,000.

ployment, the credit causes an actual reduction in taxes which ranges from $900 (for an employer in the 70-percent bracket) to $2,580 (for an employer in the 14-percent bracket).

Three other rules apply to the definition of qualified wages. First, any wages paid to an employee for whom an employer is simultaneously receiving payments for on-the-job training under Federally-funded programs such as the Comprehensive Employment and Training Act (CETA) or the Work Incentive Program (WIN) would not be qualified wages. Second, wages paid to an employee whose total number of days of employment with the employer does not exceed 75 days during the first year after beginning work for the employer would not be qualified wages. Third, no wages paid to an employee for whom a WIN or welfare recipient credit is claimed are qualified wages.

Certification of members of target groups

In order to encourage employer participation in the credit, the committee bill establishes certification provisions which relieve the employer of responsibility for proving to the Internal Revenue Service that an individual is a member of a target group. Rather, the bill requires that the Secretaries of Treasury and Labor jointly designate a single employment agency in each locality, such as the Employment Service, to make this determination and to issue a certificate which, without further investigation on the part of the employer, is sufficient evidence that the individual is a member of such a group.

The bill provides that this designated local employment agency issue certification even when another agency, such as the Social Security Administration or a state welfare agency, is in a position to determine whether an individual is a member of a target group. There are several reasons for this provision. First, the committee believes that by placing responsibility for certifications with this agency, the labor market exchange role of local employment agencies will be strengthened. Second, the various agencies involved would be extremely reluctant to deal with a myriad of employer inquiries, but would be willing to deal with a single local employment agency.

Furthermore, the committee believes that the credit can be effective only if the Secretary of Labor, the Employment Service, and local employment and training agencies aggressively promote the credit, use it as a tool in finding jobs for members of the target groups, and provide prompt certification. The bill explicitly provides that the Secretary of Labor, in consultation with the Internal Revenue Service, must take whatever steps are necessary to keep employers informed of the availability of the credit, including use of the mass media and private industry councils established under CETA. The committee believes that only through such publicity, and through the resulting interchange between employers and public employment agencies, will the intended results be achieved.

Target groups

(*1*) *Vocational rehabilitation referrals.*—Vocational rehabilitation referrals are those individuals who have a physical or mental disability which constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after com-

pleting, vocational rehabilitation services under an individualized, written rehabilitation plan under a state plan approved under the Rehabilitation Act of 1973, or under a rehabilitation plan for veterans carried out under chapter 31 of title 38, U.S. Code. Certification can be performed by the designated local employment agency, upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(*2*) *Economically disadvantaged youths.*—Economically disadvantaged youths are individuals at least age 18 but not age 25 on the date they are hired by employers, and who are members of economically disadvantaged families (defined as families with income during the preceding 6 months, which on an annual basis was less than 70 percent of the Bureau of Labor Statistics lower living standard as determined by the designated local employment agency). This definition of economically disadvantaged families is the same as that used to determine eligibility for various components of the CETA program. In preparing the regulations for this tax credit and CETA, and in implementing these programs, the Secretaries of Treasury and Labor should coordinate their interpretations of this definition to the maximum extent feasible.

The designated local employment agency is to issue the certification to employers after determining the individual's age and after a determination that the individual's family is economically disadvantaged. The agency may make these determinations in advance, but only for a limited period of time, which the Secretary of Treasury should determine. For example, if a 20 year old youth registers with the agency on May 15 and is found to have had a low family income during the previous six months, this finding should be the basis for issuing a certificate to the employer for only a limited period, such as 60 days. Thus, for hires after July 13, a further examination of the individual's income would be required.

(*3*) *Economically disadvantaged Vietnam veterans.*—The third target group consists of Vietnam veterans certified by the designated local employment agency under the age of 35 on the date they are hired by the employer and who are members of economically disadvantaged families. For purposes of the bill, a Vietnam veteran is an individual who has served on active duty (other than for training) in the Armed Forces more than 180 days, or has been discharged or released from active duty in the Armed Forces for a service-connected disability, but in either case the active duty must have taken place after August 4, 1964, and before May 8, 1975. However, any individual who has served a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual is hired by the employer. This latter rule is intended to prevent employers that hire current members of the armed services (or those recently departed from service) from receiving the credit. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as those discussed above.

(*4*) *Economically disadvantaged convicts.*—Any individual who is certified by the designated local employment agency as having at

some time been convicted of a felony and who is a member of an economically disadvantaged family is an eligible employee for purposes of this targeted jobs credit. The definition of an economically disadvantaged family and the procedures for certifying to the employer that an individual is a member of such a family are the same as those discussed above.

(*5*) *Disabled SSI recipients.*—Disabled SSI recipients are those receiving either Supplemental Security Income under Title XVI of the Social Security Act or State supplements described in section 1616 of that Act or section 212 of P.L. 93–66 by reason of their disability. Thus, individuals receiving SSI by reason of their age are not eligible employees. To be an eligible employee, the individual must have received SSI payments during a month ending during the 60-day period which ends on the date the individual is hired by the employer. The designated local employment agency must issue the certification after a determination by the agency making the payments that these conditions have been fulfilled.

(*6*) *General assistance recipients.*—General assistance recipients are individuals who receive general assistance for a period of not less than 30 days, if this period ends within the 60-day period ending on the date the individual is hired by the employer. General assistance programs are State and local programs which provide individuals with money payments based on need. These programs are referred to by a wide variety of names, including home relief, poor relief, temporary relief, and direct relief. Examples of individuals who may receive general assistance include those ineligible for a Federal program, or waiting to be certified by such a program, unemployed individuals not eligible for unemployment insurance, and incapacitated or temporarily disabled individuals. Some general assistance programs provide needs to those individuals who find themselves in a one-time emergency situation; however, many of these families will not meet the "30-day requirement" described above. Because of the wide variety of such programs, the committee has provided that a recipient will be an eligible employee only after the program has been designated by the Secretary of the Treasury, after consultation with the Secretary of Health, Education, and Welfare, as a program which provides cash payments to needy individuals.

Limitation on amount of qualified wages

To prevent the hiring of targeted employees from displacing a substantial number of non-targeted employees, the bill provides that qualified first-year wages during a taxable year cannot exceed 20 percent of aggregate FUTA wages for all employees during the calendar year ending in that taxable year. FUTA wages are the first $6,000 of wages per employee per calendar year. While for a taxpayer whose taxable year does not end in a calendar year, this limitation does not permit a perfect match between the qualified first-year wages of targeted employees and the wages of all employees, the percentage is believed to be sufficiently high to compensate for whatever mismatch is likely to occur between time periods as a result of comparing taxable year wages with calendar year wages. This limitation is much simpler than the incremental limitation which currently applies to the extra credit for vocational rehabilitation referrals.

Special rules are provided for certain agricultural and railroad employers not covered by FUTA. These rules are similar to those cur-

rently in effect for the new jobs credit and allow these employers to use their records under the social security tax (FICA) and the Railroad Unemployment Insurance Act (RUIA), respectively.

Definition of wages

Wages eligible for the credit are defined by reference to the definition of wages under FUTA, in section 3306(b) of the Code, except that the dollar limits do not apply. Special rules, similar to those referred to in the previous paragraph, are provided for certain agricultural and railroad employers.

The bill provides the credit only for employees of a trade or business of the employer. This provision excludes, for example, maids, chauffeurs, and other household employees. The bill does not allow a credit unless more than half the employee's wages are for services in the employer's trade or business. The test as to whether more than one-half of an employee's wages are for services in a trade or business is applied to each separate employer, without treating related employers as a single employer (*see*, *Other rules*, below).

Other rules

In order to prevent taxpayers from escaping all tax liability by reason of this credit, the amount of the credit may not exceed 90 percent of the taxpayer's income tax liability. Furthermore, the credit is allowed only after all other nonrefundable credits have been taken. If, after applying all other nonrefundable credits, a person's remaining tax liability for a year is less than the targeted jobs credit, the excess credit can be carried back 3 years and carried forward 7 years, beginning with the earliest year.

The bill retains several provisions of the current new jobs credit which are relevant to the targeted jobs credit. Thus, all employees of all corporations that are members of a controlled group of corporations are to be treated as if they were employees of the same corporation for purposes of determining the years of employment, of any employee wages for any employee up to $6,000, and the 20-percent FUTA cap. Generally, under the controlled group rules, the credit allowed the group is the same as if the group were constituted as a single company. A comparable rule is provided in the case of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control, so that all employees of such orgnizations generally would be treated as if they were employed by a single person. The amount of targeted jobs credit allowable to each member of the controlled group will be its porportionate share of the unemployment insurance wages giving rise to the credit.

On the other hand, several rules which were thought necessary for the general jobs credit were not retained in the bill. The purpose of the targeted jobs credit is to encourage employers to hire employees from certain specifically enumerated groups, the hiring of which the committee believes is deserving of special incentives. Because the committee's overriding concern is to provide an incentive for the hiring of employees from these groups, the bill provides for no dollar limitation on the amount of the credit. Also because most tax shelter activities would not be able to obtain sufficient credits to increase the value of the shelter, the committee decided not to limit the credit allowed to a partner, shareholder of an electing small business corporation, or beneficiary of a trust or estate to the proportionate part of the tax for the

year attribuable to the taxpayer's interest in the particular partnership, etc., from which the credit is derived.

The House bill contains a targeted jobs credit with somewhat different definitions of target groups and with no credit allowed for an employee's third year of employment.

Effective date

The provision is effective for taxable years beginning after December 31, 1978 and before January 1, 1982. A transitional rule is included to coordinate the effective date of the targeted credit for 1979 with the expiration of the existing new jobs tax credit at the end of 1978 for fiscal year taxpayers. Under the transition rule a taxpayer with a fiscal year beginning in 1978 will compute his general jobs credit under present law (but without regard to the 100 percent of tax liability limitation) for wages paid in 1978 and his targeted jobs credit under the bill (also without regard to the 100 percent of tax liability limitation) for wages paid in 1979, add the two credits together and then apply the 90 percent of tax liability limitation. The resulting credit is the amount allowed for that fiscal year.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $330 million in 1979, $547 million in 1980 and $698 million in 1981. Budget receipts will be reduced by $120 million in fiscal year 1979, $428 million in 1980, and $568 million in fiscal year 1981.

4. WIN and welfare recipient tax credits (sec. 322 of the bill and secs. 50A, 50B and 280C of the Code)

Present law

Under the current work incentive (WIN) tax credit and the associated welfare recipient tax credit, employers can receive a tax credit equal to 20 percent of the wages paid during the first 12 months of employment to individuals who have received AFDC for at least 90 days or who are placed in employment under the WIN program. The WIN credit is limited to employees of a trade or business, while the welfare recipient credit also is available for up to $5,000 of nonbusiness wages per taxpayer. The amount of the credit available to any employer is limited to $50,000 of tax liability plus one-half of tax liability in excess of $50,000. The WIN credit generally is not available if the employment is terminated without cause within a certain period after the employment starts (generally six months), although the welfare recipient credit is available for all employees who have been employed at least 30 days on a substantially full-time basis. In addition, under both credits, wages and benefits must be no less than wages and benefits paid to other employees of the employer for similar jobs, the employee for whose wages the credit is taken must not displace any individual from employment, and the employee must not be a close relative, dependent or major stockholder of the employer. The welfare recipient credit expires January 1, 1980.

Reason for change

The committee believes that employer utilization of the WIN and welfare recipient tax credit is far below what could be achieved if the

rate of the credit is increased and the rules for claiming it are simplified. Recent evaluations of these credits have indicated that employers are confused by the different rules under which credits may be claimed for AFDC recipients and WIN registrants and that the current rate of credit is too low to generate employer interest in hiring welfare recipients, who typically have low levels of education and work experience. Therefore, the committee has amended the WIN and welfare recipient tax credit to increase the rate and simplify the rules which govern employer eligibility for the credit.

Explanation of provision

The bill amends the provisions of the WIN and welfare recipient credit so that, for trade or business employment, the credit allowed in any taxable year is equal to 75 percent of qualified first-year wages, 65 percent of qualified second-year wages, and 55 percent of qualified third-year wages. For employment other than in a trade or business, the credit is 50 percent of qualified first-year wages; no credit is available for second or third year wages. Qualified first-year wages consist of wages attributable to service rendered by an eligible employee during the one-year period beginning with the day the individual first begins work for the employer. Qualified second-year wages consist of the wages attributable to service rendered during the one-year period which begins at the close of the first year described just above, and a similar definition is provided for qualified third-year wages. Thus, the date on which the wages are paid does not determine whether the wages are first-year or second-year wages; rather, the wages must be attributed to the period during which the work was performed.

Qualified wages do not include wages paid to employees who first began work with the employer before January 1, 1978. Qualified wages do not include wages paid to employees who were first hired by the employer before September 27, 1978, for services rendered after the one-year period beginning with the date the individual first begins work for the employer. However, the employer may elect to treat eligible employees in these target groups, who are hired on or after that date, for the purpose of defining first-, second-, and third-year qualified wages, as if they began work for the employer on the first day of the taxable year beginning after December 31, 1978, or, if later, the actual date they began work.

No more than $6,000 of wages during either the first, second or third year may be taken into account for a year of employment beginning in 1979 or 1980 with respect to any individual; this figure increases to $7,000 for years of employment beginning in 1981 and thereafter.[1]

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[1] For example, if a trade or business employer with a calendar year taxable year hires an eligible employee on September 1, 1979 and pays him $2,500 in that taxable year, the employer is eligible for a credit of 75 percent of the $2,500, or $1,875 in that taxable year. For the next taxable year, the employer is also eligible for a 75 percent credit on the next $3,500 paid to that employee through August 31, 1980. No credit is allowed on any additional wages paid to that employee through August 31, 1980. However, the employer is eligible for the 65-perecnt credit on any wages paid to the employee beginning September 1, 1980 until the total wages paid to the employee from that date (through August 30, 1981) equal $6,000.

Thus, for 1979 and 1980, the maximum credit per individual employed in a trade or business in 1979 or 1980 is $4,500 in the first year of employment, $3,900 in the second year of employment, and $3,300 in the third year of employment. In order to prevent the credit and the ordinary wage deduction from causing a tax reduction greater than the amount of eligible wages, and to make the percentage reduction in labor cost equal for all trade or business employers, regardless of their tax bracket, the bill provides that the ordinary deduction for wages is reduced by the amount of the credit. Thus, for a trade or business employer who hires an eligible employee who earns $6,000 in his first year of employment, the credit causes an actual reduction in taxes which ranges from $1,350 (for an employer in the 70-percent bracket) to $3,870 (for an employer in the 14-percent bracket).

The bill increases the current limitation of the credit to 50 percent of tax liability in excess of $50,000 to 100 percent of tax liability. In addition, the current $5,000 limitation on eligible wages paid for employment not in a trade or business is increased to $12,000 for 1979 and 1980 and $14,000 for 1981 and thereafter; this would allow any taxpayer to claim credit for up to two full-time nonbusiness employees. Wages with respect to which the credit for dependent care expenses is being claimed, however, would not be eligible for the credit. The separate limitation on wages paid with respect to child day care services would be eliminated.

The bill provides that the rules defining an eligible employee and the restrictions on the availability of the credit are the same for AFDC recipients and WIN registrants. Thus, an employee would have to fulfill two conditions in order to make the employer eligible for the credit. First, the employee would be either a member of an AFDC family which has been receiving AFDC at least 90 continuous days immediately preceding the date on which the individual is hired by the taxpayer or must be a WIN registrant. Second, the employee would have to be employed by the taxpayer in excess of 30 consecutive days on a substantially full-time basis. All rules relating to recapture of the credit, which currently apply only to WIN registrants, would be repealed. As under present law, WIN registrants, as well as AFDC recipients, would be eligible employees even if employed in non-trade or business activities.

The bill provides that the credit is permanent.

The House bill repeals this credit and makes WIN registrants one of the target groups in the targeted jobs credit contained in that bill. The committee believes, however, that this credit should be separate from the new, experimental, targeted jobs credit program.

Effective date

The amendments are effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $161 million in 1979, $260 million in 1980, and $455 million in 1983. Budget receipts will be reduced by $58 million in fiscal year 1979, $223 million in fiscal year 1980, and $422 million in fiscal year 1983.

5. Industrial development bond provisions

a. Small issues exception to industrial development bond tax treatment (sec. 331 of the bill and sec. 103(b) of the Code)

Present law

Present law (sec. 103(a) of the Code) provides that interest on State and local government obligations generally is exempt from Federal income taxation. However, interest on State and local government issues of industrial development bonds is taxable, with certain exceptions. A State or local government obligation is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in a trade or business of a person (unless carried on by a governmental unit or by certain tax-exempt organizations) and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in such trade or business.

An exception to the general rule of taxability of interest on industrial development bonds is provided for certain small issues (sec. 103 (b)(6)). This exception applies to issues in amounts of $1 million or less, if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. At the election of the issuer, the $1 million limitation can be increased to $5 million. If this election is made, the exception is restricted to projects where the capital expenditures and the total of a series of small issues over a six-year period do not exceed $5 million.

Both the $1 million and $5 million limitations are determined by aggregating the amounts of bond issues plus, in the case of the $5 million limitation, capital expenditures for all facilities used by the same or related persons which are located within the same county or same incorporated municipality. However, facilities located in a county are not aggregated, for this purpose, with facilities located in incorporated municipalities within that county.

Reasons for change

Since the enactment of the small issue exemption in 1968, there has been a substantial decrease in the purchasing power of the dollar. As a result, projects for which the limited small issue exemption from the industrial development bond provisions were intended no longer can qualify. The committee thus believes that both the $1 million and $5 million limitations should be increased to $2 million and $12 million, respectively.

Explanation of provision

The committee amendment increases the amount of the limitation with respect to regular small issues from $1 million to $2 million and, in addition, increases the amount of the limitation with respect to the small issue election from $5 million to $12 million.

The bill as passed by the House only increases the amount of the limitation with respect to the small issue election from $5 million to $10 million.

Effective date

The provision is effective for bonds issued after December 31, 1978, in taxable years ending after that date. The provision also specifies

that the higher limitation is to apply to capital expenditures made after December 31, 1978, with respect to bonds that were issued prior to December 31, 1978, to which the old $5 million election was made. In addition, with respect to bonds issued after December 31, 1978, the new $12 million limitation is to apply by taking bonds issued prior to December 31, 1978, into account in determining the amount of bonds that can be issued after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $3 million in 1979, $13 million in 1980, and $45 million in 1983. Budget receipts will be reduced by less than $1 million in fiscal year 1979, $4 million in fiscal year 1980, and $39 million in fiscal year 1983.

b. Advance refundings of industrial development bonds for public projects (sec. 332 of the bill and sec. 103(b) of the Code)

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, tax-exemption is denied to State and local government issues of industrial development bonds, with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property, or borrowed money, used in a trade or business.

Certain industrial development bonds do qualify for tax exemption, where the proceeds of the bonds are used to provide certain exempt activities facilities. Such facilities include convention and trade show facilities (sec. 103(b(4)(C)) airports, docks, wharves, and facilities for mass commuting, parking, or storage and training directly related to those installations (see. 103(b)(4)(D)).

Prior to December 1977, if an issue of industrial development bonds qualified as a tax-exempt bond, a refunding issue [1] of that issue may have also qualified as a tax-exempt bond. However, under proposed regulations issued December 6, 1977, advance refunding issues for industrial development bonds that are issued more than 180 days before the original issue is redeemed do not qualify as tax-exempt bonds.

The Treasury proposed this amendment to the refunding regulations because it believed that their issuance contravenes the statutory requirement that substantially all of the proceeds of an industrial development bond must be used to provide a facility described in the statute in order to qualify for tax exemption. The Treasury further be-

[1] In general, refunding issues are bonds of which the proceeds are used to redeem outstanding bonds. Refunding issues are issued typically to take advantage of lower current interest rates, or to remove restrictive covenants in the original bond issue. Advance refunding issues are bonds issued prior to the maturity date of the original bond. In an advance refunding of tax-exempt industrial development bonds both the original issue and the refunding issue remain outstanding, thereby significantly increasing the amount of tax-exempt bonds outstanding for any project.

lieves that advance refunding issues violate this requirement, since they permit the issuance of a face amount of tax-exempt bonds which when aggregated with the outstanding issue exceed the cost of a given facility commencing with the issuance of the refunding issue and ending with the call or retirement of the original issue.

Reasons for change

The general purpose of the amendment is to distinguish between advance refunding of obligations used to provide public facilities and private facilities. The committee believes that State and local governments should be allowed to advance refund industrial development bonds used to provide certain types of public facilities. Although advance refunding in general increases borrowing costs and increases the amount tax-exempt bonds outstanding for any project, the committee believes that where the refunded issue was used to provide certain public facilities it is appropriate to allow State and local governments to advance refund where the refunding will result in the removal of unfavorable conditions in the original bond issue or will result in debt service savings.

However, because advance refunding tends to increase the total outstanding tax-exempt bonds, the Comimttee has decided not to allow the advance refunding of bonds used to provide essentially private facilities. The refunding bonds, which are essentially private, it is argued compete with true municipal debt for a share of the tax-exempt market thus, increasing the costs of financing public facilities.

Explanation of provisions

The bill would allow advance refunding of certain outstanding tax-exempt industrial development bonds. Tax-exempt advance refunding is allowed where substantially all the proceeds of the refunded issue were used to provide a qualified public facility.

Under the bill, qualified public facilities are defined as: (1) public airports (such as the three New York City airports and the Dallas-Fort Worth airport), (2) public docks or wharves (such as the Galveston wharves or the Port of New Orleans), (3) public mass commuting facilities, (4) public convention or trade show facilities, or (5) public facilities for parking, storage, or training that are directly related to any of the facilities described in (1), (2), or (3). For this purpose, a facility described in (1) to (4) includes any public land, public buildings, or other public property functionally related and subordinate to such facility.

In order to determine whether an individual facility or a group of such facilities which are part of a larger qualified public facility qualify, the former facilities must also be generally available for use by the general public. For example, a dock or wharf which is owned by a nonexempt person and which is part of a larger facility will not qualify, unless the advance refunding relates to the entire larger facility.

However, if the refunded issues (taken as a whole) related generally to a qualified public facility, it is immaterial that some private properties are part of the public facility. For example, if a public airport refunds all its outstanding bonds to eliminate a restrictive covenant, it is immaterial that some of the bonds are related to privately owned

hangers located at the airport. On the other hand, if the airport refunds a single outstanding issue that relates only to a privately owned hangar or repair facility payments with respect to which are the sole security for the issue, the Committee bill does not apply.

The bill generally also prevents advance refunding of an advance refunding. Thus, no more than two tax exempt issues will be outstanding for any one project at the same time.

The bill applies to refunding bonds issued after the date of enactment. For example, if industrial development bonds were issued in 1967 and substantially all the bond proceeds were used to provide a public airport, then tax exempt advance refunding of the 1967 bonds will be allowed so long as the refunding bonds are issued after the date of enactment.

The bill is not intended to affect (by implication or otherwise) the tax treatment of advance refunding of ordinary municipal bonds.

There is no comparable provision in the House bill.

Effective date

The provision applies to refunding bonds issued after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

c. Advance refunding for certain other industrial development bonds (sec. 333 of the bill and sec. 103(b) of the Code)

Present law

Background

Prior to 1968, no distinction was made between general State and local obligation bonds and industrial development bonds. Consequently, State or local governments were able to issue bonds bearing interest which was exempt from Federal income taxation and use the proceeds from the bond issue to build manufacturing plants to attract industry.

The Revenue and Expenditure Control Act of 1968 provided generally that interest on certain industrial development bonds was not exempt from Federal income taxation. However, a transitional rule provided that interest on industrial development bonds issued prior to May 1, 1968, was to remain exempt (so-called pre-1968 bonds).

Under Treasury regulations issued in 1972, that the proceeds from obligations issued to refund outstanding tax-exempt industrial revenue bonds were considered to be issued for the purpose for which the original issue was used. These regulations also provide that obligations issued to refund obligations which would have been taxable industial development bonds, but for the fact that they were originally issued prior to the effective date of the 1968 Act, would also be tax-exempt industrial development bonds if the proceeds of the refunding issue were available only to service the debt of the original issue.

Some refundings of industrial development bonds were intended primarily to refund original issues at a lower effective cost or to extend the maturity date of pre-1968 industrial development bonds. A major portion of these pre-1968 industrial development bond refunding

issues were so-called advance refundings which were utilized to a major extent for the first time early in 1977. An advance refunding is an obligation issued well in advance of the maturity or call date of the original issue. The proceeds of the advance refunding issue are generally invested in Federal securities pending call or retirement of the original issue.

Proposed Treasury regulations

On November 4, 1977, the Department of the Treasury announced that it would propose amendments to the regulations which would substantially restrict current and advance refundings of industrial development bonds issued before and after the effective date of section 103(b). The proposed amendments were made effective with respect to refunding obligations issued after 5:00 p.m. EST November 4, 1977. On November 9, 1977, Treasury further announced that the effective date of the proposed regulations would be December 1, 1977, for refunding obligations issued to refund industrial development bonds substantially all the proceeds of which are used to provide residential real property for certain family units.

The proposed amendments to the Treasury regulations were published on December 6, 1977. The proposed regulations prohibit tax-exempt refundings of industrial development bonds issued before the effective date of section 103(b) if the refunding issue extends the maturity date of the outstanding bonds.

The proposed regulations also prohibit tax-exempt advance refunding of industrial development bonds issued after May 1, 1968, whether or not they extend the maturity date of the original issue. For this purpose, an advance refunding is a refunding obligation issued more than 180 days in advance of the maturity or call date of the original issue. The Treasury proposed this amendment to the refunding regulations because it believed that their issuance contravenes the congressional requirement that substantially all of the proceeds of an industrial development bond must be used to provide a facility described in the statute in order to qualify for tax exemption. The Treasury Department believes that advance refunding issues, it is argued violate this requirement, since they permit the issuance of a face amount of tax-exempt bonds equal to twice the cost of a given facility to remain outstanding during the period commencing with the issuance of the refunding issue and ending with the call or retirement of the original issue.

Reasons for change

The committee believes that a bond issue which refunds a previously issued tax-exempt industrial development bond should qualify for tax-exempt status where prior to the date of issuance it satisfies current conditions prescribed by the Secretary of the Treasury. The committee also believes that since many persons had expended large amounts of money, time, and effort in the preparation of refunding pre-1969 industrial development bonds it is appropriate to provide a special transitional rule for the advance refunding of such bonds.

Explanation of provision

The bill provides rules relating to the advance refunding of certain industrial development bonds. A bond issue that refunds a previously issued industrial development bond will qualify for tax-exempt status

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if it satisfies conditions prescribed or by the Secretary of the Treasury prior to the date on which the refunding obligation is issued. In addition, the bill contains a transitional rule regarding the refunding of obligations issued before the effective date of section 103(b) (April 30, 1968, or January 1, 1969, if certain transitional rules applied). This transitional rule is comparable to the procedure followed in 1968 when the industrial development bond provisions were enacted by Congress.

Under this transitional rule, an obligation issued to refund a pre-1968 tax-exempt industrial revenue bond must satisfy four tests.

First, the refunding obligation would be required to satisfy the Treasury regulations in effect before November 5, 1977, determined without regard to the proposed amendment.

Second, the refunding obligation would be required to be issued either (a) before November 5, 1977, or (b) during the period beginning on November 5, 1977, and ending on the 180th day after the date of enactment of the bill.

Third, the proceeds of the refunding issue would be required to be applied solely to the payment of principal, interest, any redemption premium on the original issue either at or prior to its maturity, and the payment of the issuance expenses of the refunding issue.

Fourth, any one of the following actions would be required to be taken prior to November 5, 1977; (1) Notice had been published of proceedings to be undertaken by the governing body toward the authorization of such bonds; (2) the issuance of the refunding issue or the proceedings toward such issuance were authorized or approved by the governing body of the governmental unit issuing the obligation or by the voters of such governmental unit or notice of such proceeding was published, (3) a bond purchase agreement for the sale of the refunding obligation had been executed, or (4) the corporation which is obligated to make payments to the governmental unit for payment of the debt service on the original issue has approved (by its board of directors, or by any committee thereof empowered to take action of that nature) participation in or proceedings toward the issuance of the refunding obligation.

If a refunding obligation satisfies these four tests and other generally applicable requirements for tax-exempt status, it will be tax exempt for any period during which it is not held by a person (or a related person) who is a substantial user of the facilities provided with the refunded issue.

The provision would not apply in a case where the refunding bonds are held by a substantial user of the facility financed by the refunded bonds (or by a related person).

There is no comparable provision in the House bill.

Effective date

The provision applies to any refunding obligation issued to refund any obligation with respect to which paragraph (4), (5), or (6) of section 103(b) of the Code applied.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $7 million in 1979, $8 million in 1980, and $9 million in 1983.

Budget receipts will be reduced by less than $1 million in fiscal year 1979, $4 million in fiscal year 1980, and $9 in fiscal year 1983.

d. Income tax exemption for bonds for water facilities (sec. 334 of the bill and sec. 103(b) of the Code)

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial development bonds, with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business not carried on by a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in a trade or business.

Certain industrial development bonds do qualify for tax exemption, where the proceeds of the bonds are used to provide certain "exempt activities" facilities. Such facilities include facilities for the furnishing of water if available on reasonable demand to members of the general public (sec. 103(b)(4)(G)).

The Internal Revenue Service has interpreted the exemption for facilities for the furnishing of water as being inapplicable where a substantial amount of the capacity of the facility is committed to the use of a small number of industrial users. The Services' interpretation is premised on the public use requirement of present law and on its view that these industrial users are not members of the general public, but rather, non-exempt persons. See Rev. Rul. 76–494 1976–2 C.B. 26. See also, Rev. Rul. 78–21 1978–3 I.R.B. 3 (January 16, 1978).

Reasons for change

The Internal Revenue Service has been reluctant to rule, under present law, that business users of water may constitute the general public; therefore, the Internal Revenue Service has refused to rule that a facility will meet the public use test where a substantial portion of the water is made available to a limited number of industrial users. The committee believes that business users are also members of the general public and that their use of a facility can satisfy the public use test provided the facility is public in the sense that it serves all or a substantial segment of all categories of users in a particular service area.

In addition, the Internal Revenue Service has interpreted existing law as not permitting a governmental unit to finance a portion of its water lines or other water facilities with tax exempt bonds unless the segment to be financed itself serves the public, notwithstanding that it may be part of an overall facility operated by the governmental unit which serves the general public in its service area. The committee believes the public use test is satisfied if the system (of which the segment being financed is a part) serves the general public, provided the segment in question is a facility for the furnishing of water and not a production facility and provided the segment is operated by the governmental unit as a part of its overall system.

Explanation of provision

The committee bill provides that interest on industrial development bonds which are used to provide government-operated facilities for the furnishing of water to the general public is tax exempt.

Generally, in order for a bond to be eligible for tax-exempt status under the bill, the facility must meet three requirements. It must be for the furnishing of water, it must be operated by a governmental unit, and it must make available water to members of the general public.

The first requirement is to ensure that a facility is in fact a facility for the furnishing of water and not a production facility. Generally, a facility will not constitute a facility for the furnishing of water if the facility uses the water in the production process. For example, if a governmental unit operates a system for the distribution of water, an individual water line for transportation of water from its main system to a single industrial user will constitute a facility for the furnishing of water. Further, the fact that an electric utility is a customer of a governmental unit which operates facilities for the furnishing of water does not transform those water facilities into facilities for the furnishing of electric energy. However, water is not made available to the general public merely because it is available for recreational use. Thus, for example, a reservoir does not make water available to the general public merely because it is available for swimming, water skiing ,etc.

On the other hand, the internal water facilities of a private plant or a cooling pond would not constitute a facility for the furnishing of water or property functionally related and subordinate to such a facility, since they are designed to handle water after it is in a usable state. Similarly, a hydroelectric dam would not constitute a facility for the furnishing of water.

The second requirement under the committee bill is that the facility be operated by a governmental unit. In order for a facility to meet the operation test, it must either in fact be operated by a governmental unit, (e.g., the governmental unit must be responsible for repairs and maintenance with respect to the facility. For example, if a facility is leased to an industrial user on a long-term basis, and the industrial user is responsible for maintenance and repair of the facility, then the facility is not considered to be operated by a governmental unit.

The third requirement under the committee bill is that the water is or will be made available to the general public. Under the amendment, the general public is not limited merely to residential users or municipal water districts; it also includes electric utility, industrial, agricultural, or other commercial users.

In order to meet the requirements of the availability test, a facility must make water available to all segments of the general public. Thus, it cannot deny access to water to residential users or municipal water districts in the service area. Notwithstanding this requirement, a water facility may enter into requirement contracts or contracts for fixed payments or contracts combining these features ("take or pay" contracts) provided that a substantial portion of the capacity of the facility is made available to other members of the general public. For example, assume a reservoir is originally built to serve a single indus-

trial user (such as a plant for converting coal into natural gas) and the industrial user agrees to "take or pay" for the entire capacity of the reservoir (but is guaranteed only 25 to 75 percent of the capacity). The facility will meet the availability test if the remainder of the water (which is a considerable quantity in absolute terms and is sufficient to serve all residential users in the service area) will be offered to other segments of the general public.

Additionally, in determining whether water is or will be made available to members of the public, a particular facility is to be viewed as a whole. Thus, if a water transmission system consisting of a main system of canals and pipelines and connecting lines serving individual industrial users and municipal water districts is extended to serve only one or two industrial users, the extensions will satisfy the availability test since the system as a whole serves the general public.

Finally, under the provision, there is no requirement that a water facility serve the general public immediately after it is constructed. It is sufficient that the facility is available to serve the general public and that the general public has an opportunity to take water from the pipeline. For example, assume that a pipeline is built to serve a region that is sparsely inhabited because of lack of water. There is no requirement that the pipeline serve the general public immediately after it is completed. It is sufficient that the pipeline will serve the general public that, attracted by a new source of water, moves into the region.

Effective date

The amendment applies to obligations issued after the date of enactment.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $4 million in 1979, $20 million in 1980, and $79 million in 1983. Budget receipts will be reduced by less than $1 million in fiscal year 1979, $6 million in fiscal year 1980, and $65 million in fiscal year 1983.

6. Other tax-exempt bond provisions

a. Bondholder taxable bond option and credit (sec. 336 of the bill and new sec. 44C of the Code)

Present law

Interest payments received from debt obligations issued by State and local governments and their instrumentalities generally are exempt from Federal income tax (sec. 103 of the Code). The exemption has been provided since the adoption of the Federal income tax in 1913.

In general, the law presently places no restrictions or conditions on issuing tax-exempt State and local government bonds or on the use of the proceeds from these bonds.[1]

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[1] In the case of industrial development bonds, the tax-exempt status is available only for small issues of industrial development bonds (up to $1 million annually) or where the total project costs involved are not over $5 million. Additional exemptions also apply to site purchases and development for industrial parks and to several types of activities such as stadiums and coliseums, residential housing, pollution control and waste disposal, and transportation, terminal and storage facilities.

Tax-exempt status also is not available for arbitrage bonds issued by State and local governments. Arbitrage bonds, in general, are issued at the lower tax-exempt bond interest rate, but the proceeds are invested in Federal Government (or other) taxable bonds carrying higher rates of interest which are not taxed when held by State and local governments. State and local bonds can lose, or not be given, tax exempt status, if the proceeds are used to produce income for a State or local government.

Reasons for change

State and local government debt competes in the market for loanable funds with issues from all other borrowers—corporations, individuals, the Federal Government—whether they issue taxable or tax-exempt bonds. As a result, the interest yields on all debt are interrelated.

From the viewpoint of State and local governments which must attract the individual investor into the tax-exempt market, interest yields on tax-exempt issues must rise until they are equal to the yield after taxes on comparable risk taxable corporate bonds. The arithmetic relationship is illustrated in the table below. Individual taxpayers in the 70 percent marginal tax bracket, for example, would find that a tax-exempt bond yield which is 30 percent of a taxable bond yield is equal to the after-tax yield on the taxable bond. For an individual in the 50-percent marginal tax bracket, the ratio must be at least 50 percent, and the ratio must be 72 percent for a taxpayer in the 28-percent bracket.

AFTER-TAX YIELD ON TAXABLE BONDS, BY SELECTED INCOME TAX BRACKETS

[In percent]

Income tax bracket	Taxable bond yields					
	10	9	8	7	6	5
70	3.0	2.7	2.4	2.1	1.8	1.5
60	4.0	3.6	3.2	2.8	2.4	2.0
50	5.0	4.5	4.0	3.5	3.0	2.5
40	6.0	5.4	4.8	4.2	3.6	3.0
35	6.5	5.9	5.2	4.6	3.9	3.2
30	7.0	6.3	5.6	4.9	4.2	3.5

Because there are relatively few persons in the highest marginal tax bracket, the increasing volume of tax-exempt issues makes it necessary for state and local governments to increase the yield on tax-exempt issues relative to taxable corporate issues substantially above the 30-percent ratio in order to attract enough investors. The higher yield on tax-exempt bonds, relative to the after-tax yields on taxable issues, attracts some of the more numerous taxpayers in lower marginal tax brackets who then find tax-exempt issues desirable investments at these higher interest rates.

As this happens, the differential between tax-exempt and taxable bonds is reduced, and higher tax-bracket investors can be viewed as receiving a windfall since they would hold tax-exempt bonds even at a lower rate of interest. The amount of the windfall is the difference between the interest yield that would be sufficient to stimulate the purchase of a tax-exempt issue by a high bracket taxpayer and the higher current market interest yield that is necessary to bring the additional investors from lower tax rate brackets into the tax-exempt bond market. The greater the difference between the current market interest rate and the interest rate which would just induce an investor to purchase tax-exempt issus, the greater is the windfall return to the investor in high marginal tax brackets.

The committee has been made aware of the so-called windfall and the opportunity to escape income taxation which may be provided to individuals in high marginal tax brackets. Analyses of the tax-exempt bond market consistently indicate that the cost to the Federal Government in foregone tax revenue of the tax exemption substantially exceeds the resulting reduction in reducing the borrowing costs of State and local government.

In the tax message he submitted to Congress earlier this year, the President recommended the enactment of a taxable bond option. The proposal would establish a taxable bond alternative for State and local governments, with the Federal Government paying 35 percent of the interest costs for obligations issued in 1979 and 1980, and 40 percent for taxable obligations issued after 1980. All tax-exempt State or local government obligations would be eligible for the election, including tax-exempt industrial development bonds. Obligations held by a related entity, however, would be eligible only if the obligations were issued through a competitive public offering. The Federal Government would become liable for its interest subsidy payment at the time the State or local government makes its interest payment. A Federal entitlement would be established for the Federal interest subsidy amounts.

That proposal was intended to reduce the windfall element in the tax-exempt bond market, thus substantially reducing the interest cost of State and local government borrowing at only modest additional cost to the Treasury. The issuance of taxable bonds would broaden the market for State and local government debt because the higher yield taxable bonds would be attractive to individuals in the lower marginal tax brackets and the tax-exempt institutions, e.g., pension funds which purchase only higher yield taxable bonds.

Substantial objection to this proposal was presented by officials of State and local governments. They opposed any Federal action which might be interpreted as an encroachment on their present authority; even their choice to issue tax-exempt or taxable bond issues could be construed as the first step toward eventual legal limitations on their ability to issue tax-exempt obligations. Furthermore, they feared that the tax-exempt market might atrophy because of substantial use of the taxable bond alternative several years in a row. The Federal Government, simply through legislative action, might change the terms of the subsidy to the disadvantage of State and local governments, or alternatively, sufficient funds might not be appropriated to meet the costs of the Federal subsidy.

In view of these concerns, the committee did not adopt the Administration proposal. However, in an effort to broaden the market for State and local debt, and to narrow the cost-benefit margin of the present Federal income tax exclusion for interest on State and local debt, the Committee has approved an optional tax credit for holders of State and local debt obligations.

Explanation of provision

General.—Under the committee bill, holders of certain tax-exempt bonds would be given an election either to exclude from gross income the interest on the tax-exempt bonds or to include in gross income 167 percent of such interest and claim a tax credit equal to 67 percent of the amount of the tax-exempt interest on the bond. The 67-percent rate for the credit generally provides a bondholder who elects the credit the same tax advantage as tax exemption would provide to a taxpayer in the 40-percent tax bracket. Generally, taxpayers with a marginal federal income tax rate of 40 percent or more would elect to exclude the tax exempt interest from their gross income.[1] On the other hand, taxpayers with a marginal federal income tax bracket of less than 40 percent would elect to include both the interest and the credit in gross income and claim the tax credit. The effect of the provision is to broaden the market for tax-exempt bonds. It would not affect the method in which tax-exempt bonds are issued and would not subject issues of tax-exempt bonds to any regulation by the Department of the Treasury. Further, for purposes of State statutes and constitutional provisions establishing interest ceilings on borrowing, the credit to electing bondholders should not be attributed to the State or local government.

Gross-up.—If a bondholder makes an election to include tax-exempt interest in gross income, the amount so includible is 167 percent of the interest received. Thus, if a bondholder who receives $1,000 of tax-exempt interest in 1980 makes the election for such year, he must include $1,670 ($1,000 interest times 167 percent) in gross income for such year. In effect, the bondholder includes both the interest and the 67-percent credit in gross income.

The amount of the credit is designed to achieve the same result as a 40 percent direct Federal subsidy to State and local governments for interest costs. However, rather than channeling the subsidy through the issuers to the bondholder, it would in effect be paid directly to the bondholders by the Federal government. Thus, while the subsidy would go to the bondholder it would benefit the State and local governments by allowing them to borrow money at interest rates approximately 40 percent below the intereset rates paid by other borrowers.

The following example illustrates the manner in which the subsidy operates: Assume a bondholder owns a $10,000 tax-exempt obligation which carries interest of 6 percent per annum. The bondholder will receive two economic benefits under the bill. First, he or she will receive $600 in interest income from the bond issuer. In addition, the Federal government will give the electing bondholder a credit against his or her liability in the amount of $400 ($600×67% = $400). Thus the bond-

[1] Taxpayers in the 40-percent marginal tax bracket would be indifferent between the exclusion or the tax credit.

holder has received $1,000 worth of economic benefits for the use of his or her bond loan proceeds. However, the issuing government pays only $600 to the bondholder for the use of the bondholder's money. The remaining $400 comes from the Federal government in the form of a $400 refundable tax credit.

Amount of credit and eligibility.—Under the bill, generally any person is eligible to make the bondholder election. Thus, tax exempt organizations (including charities and qualified pension and profit sharing plans) are eligible for the bondholder election. If a bondholder makes an election to include tax-exempt interest in gross income, the amount of the credit he may claim against his federal income tax liability is 67 percent of the tax-exempt interest received in the year for which the election is made. Thus, if a bondholder receives $1,000 of tax-exempt interest in a year for which an election is made, the bondholder may claim a tax credit of $670 ($1,000 tax-exempt interest received times 67 percent). The credit is a refundable tax credit for certain institutions not subject to Federal income tax, such as certain pension funds and tax-exempt organizations, and is nonrefundable for everyone else.

Refundability.—In general the credit received under this provision is nonrefundable. However, cetrain tax-exempt organizations (i.e., tax-exempt charities and qualified pension plans) are generally entitled to a refund.

Obligations eligible for bondholder election.—In general, all types of obligations which are issued after the effective date and which, under present law are exempt from tax under the Internal Revenue Code are to be eligible for the bondholder election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. However, industrial development bonds, as that term is presently defined in the Internal Revenue Code, are not to be eligible for the election even if those bonds are eligible for tax exemption under the Code. Also, obligations not exempt under the Internal Revenue Code are not to be eligible for the election. This would include arbitrage bonds, which are denied tax exemption under the Code, and obligations which are exempt but which obtain their exemption from provisions outside of the Internal Revenue Code. Bonds or other obligations issued pursuant to specific Federal programs, for which tax exemption is provided in Federal statutes outside the Internal Revenue Code, are to be eligible for the bond election, however, if the obligations could have qualified for exemption under the Internal Revenue Code had they not been issued pursuant to the specific Federal program.

The bill also provides that obligations which receive some form of direct financial assistance from the Federal Government are not to be eligible for the taxable bond election. Obligations on which the United States guarantees part of the principal or interest and those on which the United States is liable to pay any part of the principal or interest (other than under this taxable bond program) are not to be eligible for the bondholder election. Furthermore, obligations which the United States is committed to purchase as a means of providing financial assistance for the obligations are not eligible for the

election.[2] The bill requires that where the United States provides any other form of financial assistance which has the effect of subsidizing or guaranteeing the principal or interest of the obligations, the obligations are not eligible for the election. This provision is limited, however, to assistance which relates directly to the principal or interest of the obligations, rather than any assistance which may be provided for the programs conducted or the design or use of the facilities which are created through the use of the proceeds of the obligations.

In addition, obligations made taxable by provisions of Federal law outside the Internal Revenue Code are not to be eligible for the election. For example, obligations issued under specific Federal programs (which may or may not be granted Federal guarantees or other forms of Federal assistance) which would be tax exempt under the Code, but are made taxable by the Federal statutes authorizing the program, are not to be eligible for the optional credit.

Finally, any obligation which is held by a related entity if the obligation is not issued pursuant to a public underwriting is not eligible for the election. This requirement is intended to prevent a situation where a State or local government issues taxable obligations, with the accompanying Federal subsidy, which are sold to a related entity at terms that do not reflect arm's-length bargaining. Without a special provision in the bill, a State or local government could obtain an increased subsidy for the related entity holding the obligation by inflating the interest rate of the obligation. However, the committee concluded that where these obligations are distributed through a public underwriting any reasonable test of arm's-length bargaining has been met and the Federal Government can be assured that the interest rate on any obligation held by related entities is not being overstated.

The bill establishes two tests to define a public underwriting. First, competitive bids for the rights to sell the obligation to the general public must be solicited from independent parties, such as underwriters. Second, 25 percent or more of the obligations sold must be acquired by persons which are not related entities. This public underwriting definition is consistent with the normal process of issuing obligations through an independent underwriter (who submits bids to the issuer for the right to distribute the obligations) for sale to the general public.

In cases where only one bid is submitted by an underwriter, the competitive bidding requirement will have been met if that underwriter is an independent party and if the issuer solicited bids for more than one such underwriter. Underwriters which are commercial banks or margin investment banking firms would, of course, normally be considered to be independent parties as long as they engage in arm's length bargaining with the issuing government.

In cases where the underwriter buys the bonds from the issuer for resale to the general public, the 25-percent test is not to be met merely because the bonds are sold to that underwriter (or other intermediaries which purchase the bonds for resale). Instead the test is to be met by

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[2] In these cases, the United States generally provides assistance by purchasing or promising to purchase the obligations at a price higher than the market price as a means of guaranteeing the bonds or subsidizing a below market interest rate.

looking at those who purchase the bonds for investment purposes. The 25-percent test is to be met only if 25 percent of the face value of the obligations (disregarding any premium or discount) is acquired by persons other than related entities, regardless of the number of obligations held by those entities.

The bill defines related entities to include, in the case of obligations of either a State or a municipality of that State, that State and any political subdivision of that State. Thus, unless the bonds are issued under a public offering, bonds of one municipality cannot be purchased by another municipality within the same State and still be eligible for the taxable bond election. Furthermore, the State cannot, except through the public offering procedure, buy obligations of any of its municipalities nor can municipalities buy obligations of their State. Under this provision any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) is treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of that municipality, of all other municipalities in that State, and of that State government. Finally, in the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States are considered to be related entities to the instrumentality.

Regulated investment companies and certain other entities.—Under present law mutual funds may, under certain circumstances, distribute to their shareholders dividends which are excludible from gross income, but only to the extent of the amount of the mutual fund's interest income which is excluded from gross income under 103(a). The bill provides that mutual funds may elect the credit with respect to qualified tax-exempt interest to the extent that it is not attributable to amounts designated as exempt-interest dividends. The treatment of certain other entities, such as subchapter S corporations, partnerships, estates and trusts is to be determined pursuant to regulations prescribed by the Secretary.

Time and manner of making election.—The election to claim the credit is to be made with the federal income tax return filed for the taxable year in which the interest or dividend is received. If the election is made for a taxable year, it must be made for all tax-exempt interest and dividends received for such year. The election must include a list of the names of the issuers or regulated investment companies, and in the case of interest (1) the date of issuance of the obligations, and (2) any other information which the Secretary of the Treasury requires. The bondholder may make the election to include the tax-exempt interest in gross income for one year and to exclude the interest on the bond for another taxable year. However, an election once made for a taxable year is irrevocable. If the bondholder decides to exclude municipal bond interest from his gross income, he will not have to take any specific action (such as completing an election tax form or checking any box on his personal tax return).

Interest on indebtedness incurred to hold municipal bonds.—The bill provides that interest paid or incurred on any tax-exempt bond for which an election is made to include such interest in gross income

remains subject to the interest disallowance rules (sec. 265) and other rules apply to tax-exempt income.

Arbitrage rules.—For purposes of the arbitrage rules, the interest yield of the obligations of an issue is to be determined generally in the same manner as it is determined under present law for tax exempt obligations.

Effective date

This provision applies to tax-exempt bonds issued after June 30, 1979. Any refunding of an obligation for which an election could not be made will also not be eligible for the election.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $38 million in 1979, $186 million in 1980, and $607 million in 1983. Budget receipts will be reduced by less than $1 million in fiscal year 1979, $30 million in fiscal year 1980, and $467 million in fiscal year 1983.

b. Declaratory judgment relating to the Status of State and local government obligations (sec. 337 of the bill and new section 7478 of the Code)

Present law

Present law provides that interest on State and local obligations is generally tax-exempt. However, tax-exempt status is denied to industrial development bonds (section 103(b) of the Code) and arbitage bonds (section 103(c) of the Code).

Although it is not necessary for the issuer of State and local bonds to obtain a determination as to the status of a bond issue, as a practical matter if an issue is seemingly in conflict with any ruling or regulations published by the Internal Revenue Service it cannot be marketed. This is the case, regardless of the validity of the Service's ruling or regulations.

In addition, an issue may not be marketable due to uncertainty as to whether it is issued by a State or local government within the meaning of section 103(a), e.g. whether the obligations are issued by an authority "in behalf of" a State or local government.

Reasons for change

As a practical matter, there is no effective appeal from a Service private letter ruling (or failure to issue a prviate letter ruling) that a proposed issue of municipal bonds is taxable. In those cases, although there may be a real controversy between a State or local government and the Service, present law does not allow the State or local government to go to court. The controversy can be resolved only if the bonds are issued. a bondholder excludes interest on the bonds from income, the exclusion is disallowed, and the Service asserts a deficiency in its statutory notice of deficiency. This uncertainty coupled with the threat of the ultimate loss of the exclusion, invariably makes it impossible to market the bonds. In addition, it is impossible for a State or local government to question the Service rulings and regulations directly.

The committee believes that a State or local government should have a right to court adjudication in the situation described above. The bill deals with the problem by providing that, in the event of an unfavor-

able private letter ruling (or failure to issue a ruling), the State or local government may ask the Tax Court, the Court of Claims or a district court of the United States for a declaratory judgment as to the tax status of a proposed issue of municipal bonds.

While this new declaratory judgment procedure is being made available to State and local governments that desire to use it, there is no requirement that they use this new procedure to determine the tax status of municipal bonds. Further, the bill imposes no requirement as a condition for tax exemption, that a request for a private letter ruling be made.

Explanation of provisions

In general

The bill provides that the United States Court, the United States Court of Claims and the district courts of the United States are to have jurisdiction in the case of an actual controversy involving a private letter ruling by the Internal Revenue Service with respect to the tax status of a proposed issue of municipal bonds.

In order to satisfy the court that is hearing a case under this section that an actual controversy exists, State or local governments will have to adopt a bond resolution in accordance with State or local law authorizing the issuance prior to the time it files an action for declaratory judgment. However, the bond resolution may be contingent on a favorable determination.

The Tax Court, the Court of Claims and the district courts of the United States to have jurisdiction to make a declaration with respect to the tax status of any proposed issue of municipal bonds. Any such declaration is to have the force and effect of a final judgment or decree and is to be reviewable as such. The court that is hearing a case under this section is to base its determination upon the reasons provided by the Internal Revenue Service in the private letter ruling and not on a general examination of the provisions of the bond indenture and related documents. Of course, if an unfavorable ruling is based on a published ruling or regulation (including a proposed regulation), the court may rule on the validity of the published ruling or regulation.

A judgment in a declaratory judgment proceeding is to be binding upon the parties to the case, and is to foreclose future legal action by them to redetermine the tax status of the bonds.

Procedure

It is anticipated that the normal rules of the Federal courts as they relate to declaratory judgments are to be applicable under the declaratory judgment procedure. Further, the courts will be required to expedite declaratory judgment cases.

Exhaustion of administrative remedies required

For a proposed issuer to receive a declaratory judgment under this provision, it must demonstrate to the court that it has exhausted all administrative remedies which are available to it within the Internal Revenue Service for a private ruling letter, that the Internal Revenue Service has either failed to act, or has acted adversely and that it has exhausted its right to appeal any adverse determination. Thus, where a proposed issuer receives a written adverse determination from

the Service and it has exhausted its right to appeal the determination, it is considered to have exhausted its administrative remedies and may immediately file an action for declaratory judgments. However, to exhaust its administrative remedies, a proposed issuer must satisfy all procedural requirements of the Service. For example, the Service may decline to issue a private letter ruling if a State or local government fails to supply the Service with the necessary information on which to make a determination.

A proposed issuer is not to be deemed to have exhausted its administrative remedies in cases where there is a failure by the Internal Revenue Service to make a determination before the expiration of 60 days after a request (complying with the procedural requirements of the Internal Revenue Service) for such a determination was made. Once this 60-day period has elapsed, a proposed issuer that exhausted its remedies may bring an action even though no private letter ruling has been issued by the Internal Revenue Service.

No action for declaratory judgment may be filed after 90 days from the date on which the Secretary or his delegate sends notice to a person of a private letter ruling (including refusals to issue such a ruling) as to the tax status of the bonds.

Tax court commissioners

In order to provide the United States Tax Court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide.

There is no comparable provision in the House bill.

Effective date

The amendments shall apply to requests for determinations filed with the Internal Revenue Service after December 31, 1978.

Revenue effect

This provision is not expected to have any revenue effect.

c. Treatment of certain arbitrage profits from advance refunding of State and local government obligations (sec. 338 of the bill)

Present law

Present law provides that interest on obligations of state and local governments generally is exempt from Federal income tax. Prior to 1969, State and local governments were able to invest the proceeds of their tax exempt obligations in higher yielding taxable obligations (usually U.S. Treasury bonds) thereby earning an arbitrage profit. In 1969 the tax-exempt status of arbitrage bonds was withdrawn. Arbitrage bonds were defined as bonds all or a major portion of the proceeds of which are invested in materially higher yielding securities, or proceeds of which are used to replace funds which were used directly or indirectly to acquire higher yielding securities.

As a result of these restrictions on the investment of the proceeds of municipal obligations, a windfall profit is created. The windfall profit represents, in general, the differential between the yield on the tax exempt obligations and taxable obligations. In order to comply with the yield restrictions on obligations acquired with the proceeds

of their obligations, some State and local governments purchased taxable bonds at a premium. This had the effect of reducing the effective yield on the acquired obligation. Typically, the windfall profit created from the payment of a premium would go either to the bond broker selling the acquired obligation, or would be diverted to charity. Where the charity performed functions which the issuer would otherwise perform, the benefit to the issuer arguably constituted a prohibited return on the investment of its bond proceeds.

Pursuant to authority granted under section 103(c)(6) to prescribe regulations to carry out the purposes of section 103(c), the Treasury announced (in news release WS 1097) regulations affecting bonds issued after 5:00 p.m. Eastern Standard Time on September 24, 1976. The proposed regulations provided that in calculating the yield on obligations acquired with the proceeds of a refunding issue for the purpose of determining whether such yield is materially higher than that of the refunding issue, the market price of the acquired obligation as determined by reference to an established market shall be used. These regulations prevent issuers from diverting arbitrage profits (or windfall) to underwriters or other third parties. Although the regulations, by their terms, apply prospectively only, the Internal Revenue Service rulings policy has been to apply the regulations retroactively.

Reasons for change

Prior to the release of the October 29, 1976 proposed regulations, many persons had spent considerable money, time and effort in preparation of refunding various tax-exempt obligations. In certain situations the refunding plan contemplated that the windfall profit would be paid to a charity.

In view of the circumstances the committee believes that it is unfair and inequitable to apply these regulations retroactively.

Explanation of provision

The provisions, in general, prohibit the Treasury from applying the position taken by the regulations retroactively to prevent windfall profits from being donated to an exempt organization described in section 501(c). In addition, where windfall profits were put into escrow pending donation and then were paid over to the Treasury Department because of the Internal Revenue Service rulings policy, the provision directs the Treasury to return the windfall so that it can be given within 90 days to the intended beneficiary.

There is no comparable provision in the House bill.

Effective date

The provision is effective on the date of enactment of the bill.

Revenue effect

This provision will not have any revenue effect.

7. Small business corporations (subchapter S)

a. Subchapter S corporation allowed 15 shareholders (secs. 341–345 of the bill and sec. 1371 of the Code)

Present law

Subchapter S was enacted in 1958 in order to minimize the effect of Federal income taxes on the form in which a business is conducted by

permitting incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and shareholder levels. The subchapter S rules allow a corporation engaged in an active trade or business to elect to be treated for income tax purposes in a manner similar to that accorded partnerships. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is revoked or terminated.

In order to be eligible for a subchapter S election, the corporation generally must have 10 or fewer shareholders. After a corporation has been an electing subchapter S corporation for 5 consecutive taxable years, it may increase its number of qualifying shareholders to 15. In addition, the number of shareholders may exceed 10 (but not 15) where the additional shareholders acquire their stock through inheritance.

Reasons for change

The committee believes that increasing the permitted number of shareholders to 15 in all situations will simplify existing law by deleting the conditions under which a small business corporation may increase its permitted number of shareholders from 10 to 15. This change will facilitate the use of the subchapter S provision by certain closely-held businesses.

Explanation of provision

Under the bill, the number of shareholders permitted in order for a corporation to qualify for and maintain subchapter S status is increased from 10 to 15.

The House bill contains an identical provision.

Effective date

The provision applies to taxable years beginning after December 31, 1978.

Revenue effect

This provision will have a negligible effect on revenues.

b. Permitted shareholders of subchapter S corporation (sec. 342 of the bill and sec. 1371 of the Code)

Present law

For purposes of determining the maximum number of shareholders a corporation may have in order to be eligible for a subchapter S election, present law provides that stock which is community property of a husband and wife (or the income from which is community property income) under the law of a community property State will be treated as owned by one shareholder. Similarly, a husband and wife are treated as one shareholder where they own the stock as joint tenants, tenants in common, or tenants by the entirety.

Also, a surviving spouse and the estate of a deceased spouse (or the estates of both deceased spouses) are treated as one shareholder

where the husband and wife were treated as one shareholder at the time of the death of the deceased spouse.

Reasons for change

The committee believes that a husband and wife (or their estates) should only be counted as one shareholder for purposes of determining the number of shareholders in a small business corporation without regard to the manner in which the stock is owned by the married couple.

Explanation of provision

Under the provision, a husband and wife (and the estates of the husband and the wife) are to be treated as one shareholder for purposes of determining the number of shareholders in a corporation in order to determine if it is eligible to qualify as an electing small business corporation.

The provision also clarifies existing law by providing that the grantor of a grantor trust is treated as the shareholder, rather than the trust, for purposes of determining whether the corporation qualifies as a small business corporation.

The House bill contains an identical provision.

Effective date

The provision applies to taxable years beginning after December 31, 1978.

Revenue effect

This provision will have a negligible effect on revenues.

c. "Simple" trusts permitted as subchapter S shareholders (sec. 343 of the bill and sec. 1371 of the Code)

Present law

Prior to the Tax Reform Act of 1976, a corporation could not elect to be treated as a subchapter S corporation if it had a trust as a shareholder, and an election would be terminated if a trust became a shareholder. However, an estate was permitted to be a shareholder. Under the Tax Reform Act of 1976, voting trusts and grantor trusts are permitted to be shareholders in subchapter S corporations. Each beneficial owner of stock in a voting trust is considered a shareholder for purposes of determining the number of shareholders. In addition, the 1976 Act permits testamentary trusts to be shareholders in subchapter S corporations for a limited period of 60 days. However, this "60-day rule" does not apply to a grantor trust following the grantor's death, although, in many cases, these trusts are used as will substitutes.

Reasons for change

The committee believes that trusts which are required to distribute all their income currently to the beneficiaries should be permitted to qualify as shareholders in an electing small business corporation.

Explanation of provision

Under the provision, a trust required to distribute all its income currently would be eligible as a shareholder in an electing small business corporation. Each beneficiary will be treated as holding the stock

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held by the trust for purposes of determining whether the corporation is eligible to make the subchapter S election. However, a simple trust will not qualify if it has another trust, a partnership, or a corporation as a beneficiary.

The definition of trust income is modified to provide that any undistributed taxable income treated as gross income to the trust will be treated as trust income and therefore be includible in the beneficiary's income (under section 652). Likewise, a corresponding change provides that distributions of previously taxed income will not be treated as trust income in order to prevent the income from being taxed twice where distributed to the beneficiary who had previously reported the income.

Net operating losses of the corporation which are flowed through to its shareholders (under section 1374) will be taken into account by the trust, but will not be flowed through to the beneficiaries until the termination of the trust. The Secretary of Treasury may prescribe regulations (under section 642(h)) to prevent the shifting of losses from income beneficiaries to remainder beneficiaries.

There is no comparable provision in the House bill.

Effective date

This provision will be effective for taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $1 million annually.

d. Extension of period for making subchapter S elections (sec. 344 of the bill and sec. 1373(c) of the Code)

Present law

Present law requires that in order for a subchapter S election to be effective for a taxable year, it must be filed during a 2-month period which begins 1 month before the start of the taxable year. (For example, if a calendar year corporation wishes to elect subchapter S effective for 1978, the election must be filed during December of 1977 or January of 1978.) An election is not valid for either the intended year or any future year if it is not filed within this period. Extensions of time for filing the election are not granted. Rev. Rul. 60–183, 1961–1 C.B. 625. If an election is found to be untimely upon audit several years later, the corporation is taxed as a regular corporation for all the intervening years, *Opine Timber Co., Inc.*, 64 T.C. 700 (1975); *Joseph W. Feldman*, 47 T.C. 329 (1966).

In effect, the period of time during which an election can be made by a newly-formed corporation for its first taxable year is only one month since a new corporation cannot make the election until it is in existence under State law, which generally occurs at the same time as the beginning of its first taxable year. *J. William Frentz*, 44 T.C. 485 (1965), aff'd, 375 F.2d 662 (6th Cir. 1967). In other situations, it has been difficult to determine when the 1-month period begins for a

new corporation because of several alternative rules used to determine when its first taxable year begins.

Reasons for change

In many instances an apparent timely subchapter S election may be invalid because the election was not filed within the limited period of time allowed under present law. In the case of a new corporation, this problem is particularly acute because of the alternative tests for determining when a corporation begins its existence. An invalid election may affect the shareholders for several years because they may not realize the election is invalid until an audit occurs several years later. In this case, a retroactive election may not be made, and subchapter S status is not available for any of these years.

The limited 2-month rule, applicable to corporations making the election for a year other than the year in which they are formed, was intended to require the corporation to make the election before it could predict its profitability for the year with any certainty. This rule helps preclude use of subchapter S as a tax avoidance mechanism. Extending the period of election to encompass the entire preceding year does not provide any tax avoidance possibilities, and should reduce inadvertent untimely elections by allowing them to be made when they are first considered during the preceding year, rather than having to wait until the last month of the year.

Explanation of provision

Under the bill, the period of time to make the subchapter S election is expanded to include the entire preceding taxable year of the corporation. In addition, the bill would permit all corporations to make the election during the first 75 days of the taxable year for which the election is effective.

The bill also provides that where the election is made prior to the taxable year for which it is effective, the shareholders who are required to consent to the election are those who hold stock on the day the election is made rather than on the first day of the taxable year for which the election is effective. Where the election is made during the taxable year preceding the year for which it is to be effective, no additional consents will be required where shareholders acquire stock prior to the beginning of the year for which the election is effective. This rule will also apply when an election is not timely filed for the intended taxable year but is effective for succeeding taxable years. In these cases, an individual who becomes a shareholder after the election is filed will have to affirmatively refuse to consent to the election within 60 days of becoming a shareholder to render the election ineffective.

The House bill contains an identical provision.

Effective date

This amendment is effective for subchapter S elections made for taxable years beginning after December 31, 1978.

Revenue effect

This provision will have a negligible effect on revenues.

8. Small business corporation stock (sec. 346 of the bill and sec. 1244 of the Code)

Present law

Under present law, a gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is either a short- or long-term capital gain or loss depending upon whether the taxpayer's holding period with respect to the capital asset is more than one year. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to $3,000 of ordinary income. In the case of long-term capital losses which have not been absorbed by short- or long-term capital gains, the amount of loss deductible against ordinary income, subject to the $3,000 limitation, must be reduced by 50 percent. Capital losses of corporate taxpayers are deductible only to the extent of capital gains.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders (not trusts or estates) to whom the stock was originally issued.[1]

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $25,000, except for married taxpayers filing joint returns, in which case ordinary loss treatment is limited to $50,000. Any loss in excess of the applicable annual limitation is treated as a capital loss.[2]

For stock to qualify as section 1244 stock, eight requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must adopt a written plan under which the stock will be issued and the stock may be offered for sale only during the two-year period beginning with the date of plan adoption; (3) the corporation issuing the stock must be a domestic corporation; (4) the amount of section 1244 stock issued by the corporation may not exceed $500,000, and the total stock issued plus the equity capital of the corporation may not exceed $1,000,000; (5) no prior offering of stock of the corporation or any portion of a prior offering of stock may be outstanding; (6) the stock must be issued for money or other property, subject to certain exceptions; (7) more than 50 percent of the gross receipts of the corporation must be derived from the active conduct of a trade or business during the corporation's existence or for its five most recent taxable years prior to the taxable year during which the loss is incurred, whichever period is less; [3] and (8) no subsequent

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[1] An individual who is a partner in a partnership would be entitled to this special treatment only if he were a partner in the partnership when the partnership acquired the section 1244 stock and the loss from the disposition of the stock is reflected in his distributive share of partnership items.

[2] Thus, if a married individual files a joint return with his spouse and during the taxable year disposed of section 1244 stock at a loss of $75,000, only $50,000 of the loss would be treated as an ordinary loss and the excess of $25,000 would be treated as a capital loss. Alternatively, if the individual in this example were to have disposed of his section 1244 stock in two taxable years, and if his loss in each of the two taxable years was $37,500, the loss sustained in each of the two taxable years would be treated as an ordinary loss, because the limitation is determined annually.

[3] This requirement must be satisfied at the time of the disposition of the stock.

offering of stock, simultaneous with or subsequent to the adoption of a plan to issue section 1244 stock may be made.[4]

Reasons for change

The committee believes that greater incentives are needed for investment in small business corporations. The dollar limitations for ordinary loss treatment of section 1244 stock issued by a small business corporation were established in 1958. The limits have not been increased to take into account the increasing capital needs of smaller business corporations and the effects of inflation. Thus, the committee believes that increasing the amount of section 1244 stock that qualified small business corporations may issue and increasing the amount of loss treated as ordinary loss by shareholders will assist in providing the capital needed to organize new corporations and to modernize existing plants and equipment.

Additionally, the organizers of many small business corporations that could have issued section 1244 stock have failed to comply with the written plan requirement, thus losing the intended benefits. The committee believes that the written plan requirement should be eliminated so that issuance of small business stock will not be disqualified because of either the lack of familiarity with the provision or because of the lack of qualified advice upon organization or subsequent issuance of stock.

Explanation of provision

In general, the bill would increase the amount of section 1244 stock that a qualified small business corporation could issue, repeal the equity capital limitation, increase the amount of loss that certain shareholders may treat as an ordinary loss rather than as a capital loss, and repeal the requirement of a written plan to issue the stock.

The bill increases the amount of section 1244 stock that a qualified small business corporation may issue from $500,000 to $1,000,000. The $1,000,000 limit is determined by reference to the aggregate amount of money and other property received (and to be received) by the corporation (1) for stock, (2) as a contribution to capital, and (3) as paid-in surplus as of the time of issuance of the stock. The value of the property other than money which was (or is to be) received by the corporation for its stock is equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation. For example, if a qualified small business corporation that was organized after the date of enactment of this provision issues common stock for money amounting to $600,000, the corporation subsequently may issue additional common stock which qualifies under the provisions of section 1244 in the amount of $400,000. For this purpose, the determination of the $600,000 amount is to be made at the time that stock was issued, and the determination of the $400,000 amount is to be made at the time that stock was issued.

If a qualified corporation issues common stock the aggregate value of which exceeds $1,000,000, the committee intends that the issuing

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[4] This requirement must be satisfied both at the time of plan adoption and during the two-year plan period.

corporation must designate which of the shares of stock issued are to be treated as section 1244 stock. The designation must be made in accordance with regulations to be issued by the Treasury Department.

Under present law, a domestic corporation is not treated as a small business corporation for purposes of section 1244 unless the aggregate dollar amount to be paid for its stock plus the equity capital (defined as the sum of the corporation's money and other property, such other property taken into account at its adjusted basis for determining gain) less the amount of indebtedness to persons other than shareholders does not exceed $1,000,000. The bill repeals the equity capital limitation. Thus, after the date of enactment of this bill, a corporation, assuming other requirements are met, may issue additional common stock under the provisions of section 1244 without regard to the amount of its equity capital to the extent that the amount received for the common stock to be issued does not exceed $1,000,000 reduced by the amount received for the common stock already issued.

The bill provides for an increase in the maximum amount an individual may treat as an ordinary loss on section 1244 stock for any taxable year. Under the provisions of the bill, the maximum amount that may be treated as an ordinary loss is increased to $50,000; in the case of a husband and wife filing a joint return for the taxable year in which the loss is incurred, the maximum amount that may be treated as an ordinary loss is increased to $100,000.

The bill repeals the present law requirement that a written plan to issue section 1244 stock must be adopted by the issuing corporation. Additionally, the bill repeals the present law requirement that provides that no prior offering of stock of the corporation or any portion of a prior offering of stock may be outstanding at the time a written plan is adopted.

The bill provides that a corporation may issue common stock under the provisions of section 1244 without adopting a written plan, but that only the first $1,000,000 worth of common stock may qualify as section 1244 stock. If the $1,000,000 common stock limitation is exceeded, the regulations are to provide which portion of the aggregate amount of issued common stock is qualified stock and how such shares of stock are to be distinguished as qualifying stock by both the issuing corporation and its shareholders.

The House bill contains an identical provision.

Effective date

This provision is to apply to common stock issued after the date of enactment of this Act.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

9. Accrual accounting for farming corporations (sec. 351 of the bill and sec. 447 of the Code)

Present law

In general

Under present law, a taxpayer is required to use a method of accounting for tax purposes which clearly reflects income (sec. 446). Most

taxpayers who are in the business of selling nonfarm products are required to report gross income using an accrual method of accounting and to accumulate their production costs in inventory until the products are sold. However, by reason of administrative rulings issued more than 50 years ago, taxpayers engaged in farming have been allowed to report income and expenses from farm operations on the cash method of accounting, which does not require the accumulation of inventory costs. Except for special capitalization rules applicable to citrus and almond groves, farmers also have been allowed to deduct the cost of seed and young plants purchased in one year which are intended to be sold as farm products in a later year.[1] In addition, administrative rulings have permitted farmers to deduct currently many of the costs of raising farm assets (such as costs related to breeding animals, orchards, and vineyards) which are used in the trade or business of farming. (In nonfarming businesses, such as manufacturing, similar costs generally are treated as capital expenditures and are depreciated over the useful lives of the assets acquired.) The special farming tax rules discussed above are still generally applicable to most farmers, although some restrictions were imposed on certain farming corporations and farming syndicates by the Tax Reform Act of 1976.

Also, under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it had been a long-standing Treasury position to permit a farmer to deduct expenses paid in the taxable year so long as the crops to which these expenses related were unharvested at the end of the taxable year.[2] In 1976, the Internal Revenue Service reversed this long-standing position and ruled that an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting).[3] The effective date of this ruling has been postponed so that it applies only to taxable years beginning on or after January 1, 1978.[4]

1976 Act

With certain execptions, the Tax Reform Act of 1976 required corporations (and partnerships in which non-excepted corporations are partners) engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However,

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[1] However, a farmer has not been allowed to deduct the purchase price of livestock, such as cattle which he intends to fatten for sale as beef.

[2] I.T. 1368.I–1 C.B. 72 (1922).

[3] Rev. Rul. 76–242, 1976–1 C.B. 132. The ruling was to be effective for taxable years beginning on or after June 28, 1976. Under the crop method of accounting, if a farmer is engaged in producing crops, and the process of gathering and disposing of them is not completed in the year in which the crops are planted, the costs of producing, gathering, and disposing of the crops are taken into account in the taxable year the income from the crop is realized. Treas. Reg. § 1.162–12(a).

[4] Rev. Rul. 77–64, 1977–1 C.B. 136. Also, the IRS has recently announced that a taxpayer affected by Rev. Rul. 76–242 could change to the cash method of accounting for the first taxable year beginning on or after January 1, 1978 unless the taxpayer is required to use the accrual method of accounting under section 447 of the Code. Rev. Proc. 78–22, 1978–34 I.R.B. 26 (released as IRS Information Release 2017, July 18, 1978).

subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of $1 million or less, and nurseries are not required to use the accrual method of accounting or to capitalize preproductive period expenses.[5]

A taxpayer who is required to change to an accrual method of accounting (or to revise his accrual method of accounting to capitalize preproductive period expenses) pursuant to the 1976 Act is generally allowed to spread the accounting adjustments required by the change in method over a period of ten taxable years unless the Treasury regulations prescribe different periods in various cases.

The 1976 Act provisions generally are effective for taxable years beginning after December 31, 1976. However the Tax Reduction and Simplification Act of 1977 postponed the effective date of the required accrual accounting provision until taxable years beginning after December 31, 1977, for any farm corporation if, as of October 4, 1976 (the date of enactment of the 1976 Act), either (a) two families owned at least 65 percent of the stock; or (b) three families owned at least 50 percent of the stock and substantially all of the rest of the stock was owned by employees, their families, or exempt pension, etc., trusts for the benefit of the employees.

Reasons for change

In the 1976 Act, which required certain corporations (and partnerships in which certain corporations are partners) engaged in farming to use the accrual method of accounting while allowing other taxpayers engaged in farming to continue to use the cash method of accounting for farming activities, Congress recognized a distinction between large, widely held farming corporations (and sophisticated tax shelter partnerships with corporate general partners) that have ready access to skilled accounting assistance which is often required to apply the accrual method of accounting to farming operations and small or family corporations for whom the simpler cash method of accounting was retained. In general, the committee believes that it is desirable to retain the cash method of accounting for certain corporations controlled by two or three families just as it remains available for corporations controlled by one family. These multi-family situations are generally thought to be similar to the situations of corporations controlled by a single family. In addition, the adjustments which would be required to be taken into account (generally over a 10-year period) for an existing corporation may adversely affect the corporation's ability to compete and its financial position.

The 1976 Act excepted nurseries from the required accrual accounting and capitalization of preproductive period expense rules. The

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[5] The 1976 Act also provides special rules which permit certain corporations to use an "annual accrual method of accounting." An annual accrual method of accounting is a method of accounting under which revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive period expenses incurred during the taxable year are charged to crops harvested during that year or are deducted currently. To be eligible to use this method, a corporation (or its predecessors) must have used this method for a 10-year period ending with its first taxable year beginning after December 31, 1975, and substantially all the crops grown by the corporation must be harvested not less than twelve months after planting.

basic reason for this exception was that it takes several years from the time of planting for the trees raised by nurseries to reach a marketable condition. It is not clear whether this exception in present law covers sod farms which, like nurseries, raise plants for landscaping and similar purposes. Since it takes up to 3 years to raise sod (from planting to harvesting) the committee believes that sod farms should be exempted from the accrual accounting and capitalization of preproductive period expenses rules applicable to certain corporations and partnerships engaged in farming.

Explanation of provisions

Multi-family corporations

The bill provides exceptions to the required accrual accounting and capitalization of preproductive period expenses rules (sec. 447) for certain corporations which are controlled by two or three families. Under these exceptions, the provisions requiring accrual accounting and the capitalization of preproductive period expenses will not apply to any farm corporation if, as of October 4, 1976 and at all times thereafter, either (1) two families own (directly or through attribution) at least 65 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and at least 65 percent of the total number of shares of all other classes of stock of the corporation, or (2) (*a*) members of three families own (directly or through attribution) at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the total number of shares of all other classes of stock and (*b*) substantially all of the remaining stock is owned by the corporation's employees (or by their family members within the meaning of sec. 267(c)(4) of present law) or by a tax-exempt employees' trust for the benefit of the corporation's employees.

In order to provide some degree of flexibility in encouraging employee ownership of the corporations, it is provided that, with respect to corporations described in the preceding paragraph, stock acquired after October 4, 1976, by the corporation's employees, their families, or a tax-exempt trust for their benefit will be treated as owned by one of the two or three families whose combined stock ownership was used to establish the initial qualification for this provision (as of October 4, 1976). No similar rule is applicable for purposes of the one-family exception of present law.

Since this provision is intended to preserve the use of the cash method of accounting only for certain corporations that were engaged in farming as of the date of enactment of the 1976 Act, the provision contains an additional limitation which requires that corporations must have been engaged in the trade or business of farming on October 4, 1976, and at all times thereafter. The purpose of this requirement is to prevent organizations which had the appropriate stock ownership as of that date but were not engaged in farming to subsequently engage in farming and qualify for this special exemption.

The House bill contains an identical provision.

Sod farms

The bill exempts sod farms from the requirements that certain farming corporations and partnerships use accrual accounting and cap-

italize preproductive period expenses. As is the case with the trade or business of operating a nursery, the trade or business of operating a sod farm is not a type of farming to which section 447 applies. However, this amendment to section 447 is not intended to affect the definition of "farming" under other provisions of the Code.

There is no comparable provision in the House bill.

Effective date

The provision relating to multi-family corporations applies to taxable years beginning after December 31, 1977, and the provision relating to sod farms applies to taxable years beginning after December 31, 1976.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million per year.

10. Accounting for costs of growing crops (sec. 352 of the bill)

Present law

In general, prior to 1976, farmers, nurserymen, and florists were not required to inventory growing crops. In the case of taxpayers engaged in farming, the Internal Revenue Service, in administrative rulings issued more than 50 years ago, has allowed the use of the cash method of accounting for reporting of income and expenses from farm operations. This method of accounting does not require the accumulation of inventory costs, and, therefore, farmers have been allowed to deduct the cost of seed and young plants purchased in one year which are intended to be sold as farm products in a later year. Also, under the accrual method of accounting as applied to farming, if crops are harvested and unsold at the end of the taxable year, the costs attributable to such crops cannot be deducted in the taxable year but must be treated as inventory. However, even under the accrual method, it had been a long-standing Treasury position to permit a farmer to deduct these expenses in the taxable year when paid so long as the crops to which these expenses related were unharvested at the end of the taxable year.[1]

Similarly, the Internal Revenue Service ruled that nurserymen on the accrual method of accounting could inventory their young trees only where they had reached a marketable size and stage of development and where the market value was definitely known. Also, the Internal Revenue Service has held that florists are not required to use inventories of growing plants for the purpose of calculating their net income for Federal income tax purposes and should not compute the costs of goods sold during the year by using an inventory value of growing plants on hand at the beginning and end of the taxable year.[2]

However, in 1976 the Internal Revenue Service reversed its long-standing positions and ruled that an accrual method taxpayer engaged in farming is required to inventory growing crops (unless the taxpayer uses the crop method of accounting). This ruling also provided that nurserymen using an accrual method of accounting must inventory

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[1] I.T. 1368, I–1 C.B. 72 (1922).
[2] O.D. 995, 5 C.B. 63 (1921).

growing trees and that florists using an accrual method of accounting must inventory growing plants. In each case an exception was provided for taxpayers who use the crop method of accounting.[3] The changes made by this ruling were to be applied only for taxable years beginning on or after June 28, 1976, the date the ruling was published in the Internal Revenue Bulletin. However, the effective date of this ruling has been postponed so that it applies only to taxable years beginning on or after January 1, 1978.[4]

On July 18, 1978, the Service announced that farmers, nurserymen and florists who have been using an accrual method of accounting without inventorying growing crops and who relied on the Service's former position would be allowed to change their method of accounting to the cash receipts and disbursements method of accounting, which does not require the accumulation of costs in inventory.[5]

With certain exceptions, the Tax Reform Act of 1976 required corporations and partnerships (in which non-excepted corporations are partners) engaged in farming to use the accrual method of accounting and to capitalize preproductive period expenses (sec. 447). However, subchapter S corporations, family corporations (in which one family owns at least 50 percent of the stock), corporations with annual gross receipts of $1 million or less, and nurseries are not required to use the accrual method of accounting or to capitalize preproductive period expenses. In general, the requirement that preproductive period expenses be capitalized would have the effect of requiring taxpayers to inventory (or capitalize) the costs of growing crops.

The 1976 Act provisions generally are effective for taxable years beginning after December 31, 1976.

Reasons for change

In 1976, Congress examined the area of tax accounting methods for persons engaged in agriculture. The 1976 Act required certain types of taxpayers engaged in farming to use an accrual method of accounting and to capitalize preproductive period expenses.[6] However, Congress expressed no intention that other taxpayers engaged in farming (or nurserymen or florists) should be required to change their methods of accounting by capitalizing preproductive period expenses.

It has come to the attention of the committee that the Internal Revenue Service's change of position, as announced in Rev. Rul. 76–242, may have substantial adverse impact upon many farmers, florists, and nurserymen who have been using an accrual method of accounting without inventories of growing crops. At the time they made the election of accounting methods, these taxpayers had relied on the Service's long-standing position as to inventorying of growing crops. Also, at

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[3] Rev. Rul. 76–242, 1976–1 C.B. 132. Under the crop method of accounting, if a farmer is engaged in producing crops, and the process of gathering and disposing of them is not completed in the year in which the crops are planted, the costs of producing, gathering, and disposing of the crops are taken into account in the taxable year the income from the crop is realized. Treas. Reg. § 1.162–12(a).

[4] Rev. Rul. 77–64, 1977–1 C.B. 136.

[5] Rev. Proc. 78–22, 1978–34 I.R.B. 26, also published as IRS Information Release 2017.

[6] Congress also made certain changes as to the timing of certain deductions for farming syndicates (sec. 464).

the time they elected their accounting methods, these taxpayers were generally eligible to elect the cash method of accounting for the income and deductions from their trades or businesses involving growing crops. The committee believes that it is appropriate to allow these taxpayers to continue to use their accrual methods of accounting without inventorying growing crops until the Congress has an opportunity to examine this matter in more detail. Also, the committee believes that taxpayers who are potentially affected by the ruling, but not required to use accrual accounting (under sec. 447), should be allowed to make an automatic change to the cash method of accounting for a limited period of time.

Explanation of provision

This provision permits a farmer, nurseryman, or florist who is on an accrual method of accounting and is not required by section 447 of the Code to capitalize preproductive period expenses to be exempt from the requirement of Rev. Rul. 76–242 that growing crops be inventoried. This is intended to allow taxpayers who have been using an accrual method of accounting without inventorying crops under the prior Service position to continue to do so. Since the committee understands that this revenue ruling does not affect the method of accounting of taxpayers who are growing trees for lumber, pulp or other nonlife purposes, such taxpayers are not covered by this provision.

This provision also allows those farmers, nurserymen, or florists who are eligible to use an accrual method of accounting without inventorying growing crops to elect, without the prior approval of the Internal Revenue Service, to change to the cash receipts and disbursements method of accounting with respect to any trade or business in which the principal activity is growing crops. However, this election may be initiated only with respect to a taxable year of the taxpayer beginning after December 31, 1977, and before January 1, 1981.

If a taxpayer elects to change to the cash method of accounting under this provision (or if he elects to modify his treatment of growing crops because of the operation of this provision) his change in method of accounting shall not require the consent of the Internal Revenue Service and shall be treated, for purposes of section 481 of the Code (relating to the adjustments to be made in cases involving a change in method of accounting), as a change in method of accounting initiated by the taxpayer.[7]

The House bill contains an identical provision.

Effective date

This provision generally applies to taxable years beginning after December 31, 1977. However, the rules permitting a taxpayer to

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[7] The taxpayer may elect to change his method of accounting for growing crops while still being under the accrual method pursuant to this section if he had changed to, or adopted, an accrual method of accounting in which growing crops were inventoried pursuant to the Internal Revenue Service's published position in Rev. Rul. 76–242. If he has made such an election or change of method, it is intended that he should be able to change to an accrual method of accounting not involving the inventorying of growing crops under the authority of this section.

change to the cash method of accounting apply only with respect to taxable years beginning after December 31, 1977, and before January 1, 1981.

Revenue effect

It is estimated that this provision will result in a reduction in budget receipts of less than $5 million per year.

11. Depreciation provisions

a. Asset depreciation range and class life system (sec. 361 of the bill and sec. 167 of the Code)

Present law

Depreciation in general

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, decay or decline from natural causes, exhaustion and obsolescence,[1] the acquisition cost (less salvage value in excess of 10-percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use.[2] This approach to the recovery of the cost of an asset is referred to as depreciation.

For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method, the sum-of-the-years-digits method, or any other method used consistently by the taxpayer which does not result in the allowance of greater aggregate depreciation deductions during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method (e.g., methods based on units of production, machine time, etc.). These accelerated methods are not allowed for intangible assets. Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property. (Rev. Rul. 57–352, 1957–2 C.B. 150; Rev. Rul. 59–389, 1959–2 C.B. 89.)

The key factors which determine the amount and the timing of depreciation deductions with respect to any depreciable asset are: (1) the cost of the asset; (2) the salvage value of the asset; (3) the useful life assigned to the asset; and (4) the method of depreciation (e.g., straight line or an accelerated method). Since determinations of the

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[1] If the asset is not subject to these factors, depreciation is not allowable. For example, land is not depreciable.

[2] In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

first three of these factors are essentially factual and are based on circumstances which may be unique to the taxpayer's situation, many controversies arise between taxpayers and the Internal Revenue Service on appropriate useful lives and salvage values. Thus, a major purpose for establishing the ADR system was to reduce the controversies relating to useful lives and salvage values for certain types of property. Similarly, a repair allowance system was provided to reduce controversies over the classification of expenditures as currently deductible repairs or as capital improvements.

ADR System

In general

The regular rules relating to allowable methods of depreciation generally are applicable under the ADR system. However, in the case of new tangible personal property with a useful life of three years or more a taxpayer who elects ADR may only select the straight line, 200-percent declining balance (up to 200 percent), or sum-of-the-years-digit methods. For used depreciable personal property, accelerated depreciation is limited to the 150-percent declining balance method, i.e., 150 percent of the straight-line rate.

Election

A taxpayer must make an irrevocable election to apply the provisions of the ADR system to eligible property placed in service during the taxable year. This election is applicable to all eligible assets placed in service during the taxable year and is effective as to those assets for all subsequent taxable years. This election must be made on Form 4832 and filed with the taxpayer's income tax return for each year that application of the ADR system is elected. If, in a subsequent taxable year, the taxpayer does not elect to apply the ADR system, the regular rules regarding depreciation will be applicable to any depreciable assets placed in service during that taxable year. A valid election to apply the ADR provisions must contain the taxpayer's consent to comply with all of the ADR requirements and must specify certain information (for example, the asset guideline class, depreciation period and salvage value for each vintage account established for the taxable year, and each asset guideline class for which the taxpayer elects to apply the asset guidelines class repair allowance).

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable property for which an asset guideline class and an asset guideline period have been prescribed by the Treasury Department for the taxable year of election.

Presently, with certain very limited exceptions, the ADR system does not apply to depreciable real property. Until class lives under the ADR system are prescribed for real estate, a taxpayer who has elected the ADR system may elect to determine the useful life of depreciable real property under Revenue Procedure 62–21 (which reflects the prior general IRS position on useful lives) as in effect on December 31, 1970, or on the basis of the facts and circumstances of the particular case.[3]

[3] Section 5 of Public Law 93–625.

Vintage accounts

Under the ADR system, the allowance for depreciation is computed on the adjusted basis of the assets grouped together in a vintage account. The vintage of the account refers to the taxable year during which the eligible property is first placed in service. Each eligible property may be placed in a separate vintage account or, under certain circumstances, assets in the same guideline class may be placed in the same vintage account. However, new and used eligible property may not be combined in a single vintage account. Certain other property also may not be combined in a single vintage account, e.g., property eligible for additional first-year depreciation may not be combined with ineligible property.

Certain special rules have been provided to account for the ordinary and extraordinary retirement of assets in a vintage account. Likewise, special rules are provided in connection with the recognition of gain or loss on retirements.

Useful lives and asset guideline class

In general. the estimated useful life of assets in each asset guideline class is established by the Office of Industrial Economics of the Treasury Department. Each asset guideline class consists of a category of assets that have certain common characteristics or that are utilized in the same or related activity. A class life is established to reflect generally the actual asset replacement practices being employed by taxpayers in the 30th percentile (i.e., 70 percent of taxpayers with assets in that class have experienced the same or longer asset retention periods). The taxpayer may use a depreciation life within a range (asset depreciation range) of 20 percent below or above the predetermined life of the asset guideline class. For example, if the asset depreciation period for a certain asset guideline class is 10 years, the taxpayer may elect a useful life with respect to assets in that guideline class that is not less than 8 years (20 percent below the asset depreciation period nor more than 12 years (20 percent above the asset depreciation period).

"Half-year convention" rules

Under the ADR system, two alternative conventions are provided for purposes of determining depreciation for the year during which property is first placed in service. First, the "modified half-year convention" provides that depreciation for a full year is allowed for all eligible property placed in service during the first half of the taxable year. All other eligible property will be treated as being placed in service on the first day of the next taxable year. Second, the "half-year convention" provides that depreciation is allowable for a half year for all eligible property placed in service during the taxable year. The same convention must be used for all vintage accounts of the same taxable year but may be changed as to vintage accounts of subsequent taxable years.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to de-

preciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain. Thus, if salvage value is less than 10 percent, it may be ignored. The salvage value of each vintage account must be estimated by the taxpayer at the time of electing the ADR system for assets placed in service for a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

Treatment of repairs, maintenance, etc.

Under present law, the characterization of certain expenditures for the repair, maintenance, rehabilitation or improvement of property is a factual determination. If these expenditures substantially prolong the life of an asset or are made to increase its value or adapt it to another use, the expenditures are capital in nature and are recoverable in the same manner as the cost of a capital asset. All other expenditures for repair, maintenance, etc., are allowed as a deduction during the taxable year in which paid or incurred.

If a taxpayer elects to apply the ADR provisions, the taxpayer may make a further election to apply the provisions of the asset guideline class "repair allowance." Under these provisions, a taxpayer is allowed a current deduction for amounts paid or incurred for certain repairs, maintenance and similar expenditures to the extent that the expenditures do not exceed, in general, the average unadjusted basis of all repair allowance property multiplied by the repair allowance percentage. "Repair allowance property" is eligible property in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The repair allowance percentage is a predetermined rate established for each asset guideline class. Property improvements (including the amount of repairs, maintenance, etc., in excess of the asset repair allowance) and excluded additions are capitalized in a special basis vintage account, subject to the ADR rules. If a taxpayer does not elect to use the asset guideline class repair allowance for assets in an asset guideline class, the regular rules regarding the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of property are applicable. If the repair allowance is elected, the taxpayer must maintain books and records to identify repair expenditures relating to specific classes of property, to allocate to specific classes of property the expenditures relating to properties in two or more classes, and to identify expenditures for excluded additions, e.g., expenditures which are clearly for capital items.

Recognition of gain or loss on retirement

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. Thus, under normal tax rules, each retirement of depreciable personal property (coupled with a sale, exchange, or abandonment) would result in current recognition of gain or loss.

Under the ADR system, recapture may be postponed for "ordinary retirements" of assets included in a vintage account, i.e., retirements occurring for routine causes during the range of years selected for the account. In this case, the proceeds from the retirement are added to the depreciation reserve of the vintage account. However, in the case of an "extraordinary retirement," any gain or loss resulting from

the retirement is recognized. (The characterization of gain or loss is governed by the normal rules relating to depreciation recapture and gain or loss on property used in a trade or business (secs. 1231 and 1245).) For this purpose, an extraordinary retirement would include a retirement attributable to an insured casualty.

Reasons for change

The committee believes that additional stimulus is necessary to modernize and increase the nation's productive capacity. However, because inflation has eroded the purchasing power of the dollar, businessmen have hesitated to invest in additional equipment because of the time period involved in recovering the cost. Thus, the committee believes that by reducing the cost recovery time period of equipment used in a trade or business or in connection with the production of income, additional stimulus will be provided to encourage investment in capital equipment.

In computing depreciation under the ADR system the adjusted basis of a vintage account may not be depreciated below a reasonable salvage value. Because the determination of a reasonable salvage value is a matter of estimation based upon the facts and circumstances in existence at the close of the taxable year in which an election is made to apply the provisions of the ADR system, time consuming and expensive controversies may arise in connection with an audit of the taxpayer by the Internal Revenue Service. The committee believes that these kinds of controversies are unproductive and that the estimation of a reasonable salvage value is a complexity that is not needed.

Additionally, the committee believes that many of the requirements of the ADR system (such as the current election procedure, specific reporting requirements, and participation in surveys) are burdensome and result in many taxpayers foregoing the benefits of ADR. Thus, the committee believes that the election to depreciate assets under the ADR system and the utilization of this system should be simplified so that the benefits will be available to more taxpayers.

Explanation of provision

The bill would increase the asset depreciation range from 40 percent (i.e., 20 percent above or below the asset depreciation period) to 60 percent (30 percent above or below the asset depreciation period). Thus, under the bill, the asset depreciation range would be a period of years which extends from 70 percent of the asset guideline period to 130 percent of such period. Any fractional part of a year would be rounded to the nearer of the nearest whole or half year.

With respect to the determination of depreciable basis of eligible property under the ADR system, the bill would provide that salvage value may be ignored. Thus, eligible property may be depreciated to a zero adjusted basis.

Additionally, the bill would provide that the annual reporting requirement presently in use in the case of an election to use the ADR system be eliminated in order to simplify the ARD system to make it more feasible for small businesses. However, taxpayers would be required to respond to survey requests to be used in calculating ADR standards. It is expected that no industry would be subject to such a survey more than once every 5 years. It is the committee's intention with respect to the elimination of the annual reporting requirement

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presently used that a substantially simplified substitute procedure be provided under which the taxpayer would merely indicate the various elections [4] made and submit a summary of guideline class information.[5]

It is not the committee's intention to preclude the Department of Treasury from reexamining existing class lives. Thus, if the Department of Treasury, after conducting its surveys, believes that certain class lives either should be increased or reduced or that classes should be combined, the Department of Treasury has such authority. Nor does the committee intend to preclude the Treasury Department from reexamining other aspects of the ADR system, such as the asset repair allowance provision and the treatment of retirements, with a view toward further simplification.

There is no comparable provision in the House bill.

Effective date

This provision applies to assets placed in service in taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $513 million in 1979, $1,415 million in 1980, and $3,040 million in 1983. Budget receipts will be reduced by $231 million in fiscal year 1979, $919 million in fiscal year 1980, and $2,812 million in fiscal year 1983.

b. Treasury study of tax treatment of certain Government-mandated equipment (sec. 362 of the bill)

Under the bill, the Treasury Department would be required to conduct a study with respect to the tax treatment of expenditures incurred in compliance with Federal statutes or regulations, such as the Occupational Safety and Health Act (OSHA) and the Mining Safety and Health Administration (MSHA) of the Department of Labor. The study is to include the feasibility of providing rapid 5-year amortization and special investment tax credit provisions.

The Treasury Department is to report to the Congress before April 1, 1979.

12. Other business provisions

a. Expenses relating to entertainment facilities (sec. 371 of the bill and sec. 274 of the Code)

Present law

In general

Under present law, deductions are allowable for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business or for the production of income (secs.

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[4] It is anticipated that the Department of Treasury would phrase any questions with respect to each of the elections under the ADR system so that the taxpayer may respond either yes or no or by so indicating as between various alternatives.

[5] With respect to the information summary regarding asset guideline classes, it is the committee's intention to provide the Department of the Treasury with the authority to request such information that is necessary to determine compliance with the ADR system rules and regulations. The information requested may include, for example, the asset guideline class, depreciation claimed, and the reserve for depreciation at the end of the taxable year.

162 and 212). Whether an expense is ordinary and necessary depends largely upon the particular facts and circumstances involved in each case. Ordinary and necessary business expenses which are deductible may include the cost of club dues or fees, and certain other expenditures relating to facilities. However, these expenses are deductible only if they both satisfy certain substantiation requirements (sec. 274(d)), and met the other prerequisites for deductibility.

Generally, no deduction is allowed for entertainment expenses unless the taxpayer substantiates by adequate records, or by sufficiently corroborative evidence, (1) the amount of the expense, (2) the time and place of its occurrence, (3) its business purpose, and (4) the business relationship to the taxpayer of the person or persons entertained (sec. 274(d)). In addition, ordinary and necessary expenses are deductible only if the expenses are allocable to the taxpayer's business, and are reasonable in amount, i.e., not lavish or extravagant.

Entertainment facilities

Expenses with respect to entertainment "facilities" may be deductible if (1) they are ordinary and necessary, (2) the facility is used primarily for the furtherance of the taxpayer's business (i.e., more than 50 percent of the time that it is used), and (3) the expense in question is "directly related" to the active conduct of the taxpayer's business.

For this purpose, an entertainment facility is any item of personal or real property owned, rented, or used by a taxpayer during the taxable year for, or in connection with, any activity which is of a type generally considered to constitute entertainment, amusement, or recreation. For example, entertainment facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suits, and vacation homes. However, a facility is not considered to be an "entertainment facility" if it is used only incidentally during a taxable year in connection with entertainment, and that use is insubstantial in relation to its business use. In the case of individuals and subchapter S corporations, apartments, hotel suites, vacation homes, and boats also may be subject to "vacation home" special disallowance rules if there is a certain amount of personal use of the facility, i.e., the personal use exceeds the greater of 14 days or 10 percent of rental days (sec. 280A).

If an item of property is considered to be an entertainment facility, the expenditures subject to the special entertainment facility rules include depreciation, rent, utility charges, maintenance and repair expenses, insurance premiums, salaries for caretakers and watchmen, and losses realized on the sale or other disposition of the property. These expenditures also include dues and fees paid to any social, athletic, or sporting club or organization.[1] However, expenditures are

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[1] While dues or fees paid to any social, athletic, or sporting club or organization are considered to be expenses incurred with respect to an entertainment facility, clubs operated solely to provide lunches under circumstances generally considered to be conducive to business discussions are exempted. Treas. Regs. § 1.274–2 (e) (3) (ii). In addition, dues paid to professional associations and civil organizations generally are exempt. Rev. Rul. 63–144, 1963–2 C.B. 129, 138–139. An initiation or similar fee which is payable only upon joining a club, and the useful life of which extends over more than one year, is a nondeductible capital expenditure. *Kenneth D. Smith*, 24 TCM 899 (1965).

not treated as being made with respect to a facility if they are out-of-pocket expenses, e.g., nonoperating costs such as expenditures for food and beverages. In addition, expenses attributable to a non-entertainment use of a facility are not treated as being expenses with respect to an "entertainment" facility, e.g., the use of an automobile or airplane for business travel purposes. Finally, expenses which are deductible without regard to their connection with a taxpayer's trade or business are not considered to be expenditures with respect to an entertainment facility, e.g., taxes, interest, and casualty losses.

In determining whether an entertainment facility is used primarily for business purposes, all the ordinary and necessary business use of the facility may be taken into account even though the use is not "directly related to" or "associated with" the active conduct of the taxpayer's profit-seeking activities (Rev. Rul. 63–144, 1963–2 CB 129, 137). However, only the portion of the expenses which are "directly related" to the active conduct of the taxpayer's trade or business are deductible. Thus, the use of the facility in providing entertainment "associated with" the active conduct of a trade or business is taken into account in determining if the facility is used primarily for business purposes, but only those expenses attributable to a use which is "directly related" to the active conduct of a trade or business are deductible. For example, if 60 percent of the use of a yacht is for business entertaining but only 45 percent of the use satisfied the "directly related" test, only 45 percent of the facility expenditures would be deductible.

Reasons for change

The committee believes that present law's treatment of expenses relating to entertainment facilities may encourage some taxpayers to attempt to deduct, as business expenses, items that essentially represent nondeductible personal expenses. Moreover, in some instances these expenses may be incurred largely as a method of providing additional compensation for highly paid employees and executives. The complexity of the provisions of present law make it effective administration and uniform application extremely difficult and provides significant opportunities for abuse. Consequently, and notwithstanding the fact that the committee recognizes that some legitimate business expenses may be incurred with respect to entertainment facilities, the committee believes that such expenses should be disallowed as business deductions.

Explanation of provision

The bill provides that no deduction is allowed for any expense paid or incurred with respect to a facility which is used in conjunction with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.[2]

Generally, the term "facility" includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or connection with an entertainment activity. Thus, expenses incurred

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[2] Such a facility would be considered to be an asset which is used for personal, living, or family purposes, and not as an asset used in the taxpayer's trade or business, or in a profit-seeking endeavor. As such, the investment tax credit would not be available upon the acquisition of such a facility.

with regard to entertainment facilities which are disallowed, include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments, and houses (such as beach cottages and ski lodges) located in recreational areas. However, the deduction is not affected unless the property is used in connection with entertainment. Expenses of an automobile or an airplane used on business trips will continue to be allowed. In addition, as under present law, the term "facility" includes dues or fees paid to any social, athletic, or sporting club or organization.

If otherwise deductible, the bill generally would not apply to dues or fees which are paid to civic or professional organizations, or to those which are paid to business luncheon clubs. Nevertheless, the bill would not preclude an otherwise allowable deduction for business meals merely because the expense was incurred in the dining room of a club or organization with respect to which no deduction is allowed for dues or fees.

Similarly, the bill would not disallow an otherwise allowable deduction for items relating to bona fide business expenses incurred while away from home overnight. For example, the bill generally would not apply to expenses incurred by an individual away from home at a bona fide business, trade, or professional organization meeting or convention. These expenses, however, would continue to be subject to the generally applicable rules relating to the deductibility of business travel, convention, and entertainment activity expenses.

The provisions of the bill also would be inapplicable to expenditures for tickets to sporting and theatrical events, regardless of whether the tickets are purchased individually, in a series or by the season, or by an equivalent fee which entitles the taxpayer to use a seat. Ticket costs generally would be subject either to the provisions of present law relating to entertainment activities, or to those which govern the deductibility of business gifts.

In addition, the bill would continue a number of the present statutory exceptions to the facility expense rules. Thus, for example, otherwise allowable deductions for expenditures relating to the following items would not be covered by the bill: (1) facilities located on the taxpayer's business premises and used in connection with furnishing food and beverages to employees, (2) certain employee recreational facilities, (3) facility expenses treated as employee compensation, (4) facilities made available to the general public, (5) facilities used in connection with a taxpayer's trade or business of selling entertainment for adequate and full consideration in bona fide transactions, and (6) facilities actively used in the taxpayer's business of selling such facilities. The bill, however, also continues any applicable present law limitations on these exceptions, including those pertaining to allocation of expenses.

In addition to the above-enumerated expenses, the disallowance rule would not apply to the extent that a portion of the facility otherwise qualified as one which was not an entertainment facility, or to the extent that a facility with respect to which expenses ordinarily would be denied as deductions, qualifies under one of the above exceptions. Similarly, expenses incurred with respect to certain transporation fa-

cilities, for example automobiles and airplanes, would be allowed provided that the taxpayer establishes that the facility was used primarily for the furtherance of a trade or business, and that the expenses otherwise met the ordinarily applicable rules with respect to business deductions.

Although the bill disallows deductions which are predicated upon a profit-seeking intent, it does not apply to any deduction allowable without regard to the taxpayer's trade or business or income producing activity, e.g., interest (sec. 163), taxes (sec. 164), or casualty losses (sec. 165).

In addition, the generally applicable investment credit and depreciation recapture rules are not to apply simply due to the characterization of a facility as a nontrade or business asset. These rules, however, remain effective with respect to all other events which ordinarily would require recapture.

There is no comparable provision in the House bill.

Effective date

This provision is effective for expenditures paid or incurred after December 31, 1978, in taxable years ending after December 31, 1978.

Revenue effect

It is estimated that this provision will increase calendar year liabilities by $113 million in 1979, $121 million in 1980, and $158 million in 1983. Budget receipts will increase by $51 million in fiscal year 1979, $116 million in fiscal year 1980, and $151 in fiscal year 1983.

b. Deficiency dividend procedure for regulated investment companies (sec. 372 of the bill and sec. 860 of the Code)

Present law

Under present law, a regulated investment company (commonly called a mutual fund) is generally treated as a conduit for income tax purposes. The taxable income of the company which is distributed to investors each year is taxed to them without being taxed at the company level. The company is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the company for distributions to its shareholders.

In order to qualify for conduit treatment, a company must satisfy a number of requirements. Generally, the company must be a domestic corporation which is registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust. In addition, a company must satisfy requirements relating to the portion of gross income which must consist of investment-type income, the portion of assets which must be represented by cash and securities, the portion of its income which must be distributed to the investors, and its stock ownership. With respect to distributions, the company must distribute at least 90 percent of its taxable income, determined with certain modifications and without regard to the deduction for dividends paid, within its taxable year or, with certain limitations, within the 12-month period after the taxable year (secs. 852(a) and 855).

Under present law, a real estate investment trust is taxed generally in the same manner as a regulated investment company. The Tax Reform Act of 1976 added a dividend deficiency procedure for real

estate investment trusts. However, unlike the treatment of real estate investment trusts, no deficiency dividend procedure is provided for a regulated investment company so that, under certain conditions, dividends paid after the taxable year and the following 12-month period may be taken into account for purposes of the 90-percent distribution requirement. Thus, a subsequent audit change by the Internal Revenue Service which increases income may cause the company to fail to meet the distribution requirement.

Reasons for change

The committee believes that a deficiency dividend procedure should be available to regulated investment companies because the penalty for failure to meet the distribution requirement is too severe. For this reason, the committee believes that if a regulated investment company is audited by the Internal Revenue Service and there is a resulting adjustment that would increase the amount of dividends that must be paid for the year under audit for the company to meet the 90-percent distribution requirement, the company should be allowed to pay out deficiency dividends to its shareholders and thereby avoid disqualification. This deficiency dividend procedure is only to be available where failure of the regulated investment company to meet the 90-percent distribution requirement was not due to fraud with intent to evade tax or to willful failure to file an income tax return within the required time.

Moreover, the committee believes that providing a deficiency dividend procedure for regulated investment companies is consistent with the treatment presently accorded to real estate investment trusts which are taxed in generally the same manner.

Explanation of provision

The bill provides a deficiency dividend procedure for regulated investment companies. Under the procedure, the company could make qualifying distributions after the regular period for making distributions when an adjustment by the Internal Revenue Service occurs that either increases the amount which the corporation is required to distribute to meet the distribution requirement or decreases the amount of the dividends previously distributed for that year. This deficiency dividend procedure would be available only where the entire amount of the adjustment is not due to fraud with intent to evade tax or willful failure to file an income tax return.

Interest at the regular rate would be imposed on the amount of the deficiency dividend. In addition, a penalty equal to the interest charge would be imposed, but the penalty could not exceed 50 percent of the deficiency dividend. The imposition of a penalty and interest is designed to discourage a company from reducing its current distributions of income in reliance on the availability of the deficiency dividend procedure to retain is qualified status.

The procedure is similar to the deficiency dividend procedure provided for real estate investment trusts by the Tax Reform Act of 1976.

The House bill did not contain a comparable provision.

Effective date

The bill is effective with respect to determinations made after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by about $200,000 in fiscal year 1979 and by less than $500,000 annually thereafter.

c. Safe harbor rule for real estate investment trusts (sec. 373 of the bill and sec. 856 and 857 of the Code)

Present law

Under present law, a real estate investment trust (commonly called a "REIT") is generally treated as a conduit for income tax purposes. The taxable income of the REIT which is distributed to its shareholders each year is taxed to them without being subject to a tax at the REIT level. The REIT is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the REIT for its distributions to its shareholders. The Code contains a number of provisions which permit the conduit treatment only where the REIT does not engage in an active trade or business.

Under one of these rules that was in effect prior to the Tax Reform Act of 1976, a REIT could not hold any property primarily for sale in the ordinary course of its trade or business. If a REIT did hold any property primarily for sale, it did not qualify for tax conduit treatment that year.

This "primarily held for sale" rule produced a particularly harsh result where the REIT acquired property through a foreclosure of a lease or mortgage. As a result, Congress provided in 1974 a special rule for foreclosure property which permitted the REIT to hold property acquired by foreclosure for a period of 2 years (with permissible extensions by the IRS for another 2 years) if the REIT paid the normal corporate income tax on income from the foreclosure property. This special rule for foreclosure property permitted a REIT a reasonable period to orderly liquidate the foreclosure property.

While the foreclosure property rules provided substantial relief, disqualification was a harsh penalty to impose where a REIT had only a relatively small amount of property primarily held for sale which was not subject to the foreclosure property rule. As a result, Congress, in the Tax Reform Act of 1976, removed the restriction for property held for sale and, in its place, imposed a 100-percent tax on gain from property held primarily for sale. The congressional intent in imposing the 100-percent penalty tax was to permit a REIT to hold property primarily for sale, but to not let the REIT derive any profit from holding property primarily for sale.

Reasons for change

Despite the fact that the 100-percent penalty tax is more lenient than the complete disqualification rule under the pre-1976 Act law, the penalty tax may restrict the ability of a REIT to change a substantial portion of its real estate investments, particularly because it is often very unclear whether property is being held by a REIT primarily for sale. The committee believes that REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire

amount of the appreciation in those assets. However, the committee believes that this safe harbor rule should be restricted to only types of assets which are owned and operated by the REIT for a substantial period of time and to which the REIT has not made substantial improvements during the last four years that it owned the property. In addition, the rule is limited to cases where the REIT had no more than five sales during the taxable year. The committee believes that these restrictions will prevent REITs from using the safe harbor rule to permit them to engage in an active trade or business such as the development and subdivision of land.

Explanation of provision

The bill provides that the 100-percent penalty tax on property held primarily for sale by a REIT will not apply to the sale of property where the following conditions are met: (1) the property has been held by the REIT for at least four years, (2) the total expenditures made by the REIT during the four-year period prior to sale do not exceed 20 percent of the net selling price of the property, (3) the REIT does not sell more than five properties during the taxable year, and (4), if the property is land or improvements not acquired through foreclosure, the property is held by the REIT for rent for a period of at least four years.

For purposes of the four-year holding requirement, the length of time that the REIT is deemed to hold the property that was acquired by the REIT through foreclosure (or deed in lieu of foreclosure), or termination of a lease, includes the period that the REIT held the loan which secured the property or that the REIT was the lessor of the property.

For purposes of the 20-percent expenditure requirement, any expenditures on property that has been acquired by the REIT through foreclosure (or deed in lieu of foreclosure) or termination of a lease, which are made by, or for the account of, mortgagor or lessee after the default became imminent, are considered to be expenditures made by the REIT. Nonetheless, expenditures (including expenditures regarded as made by the REIT under the prior rule) do not count towards the 20-percent limitation if the expenditures relate to the foreclosure property and those expenditures did not cause the property to lose its status as foreclosure property. In addition, expenditures made solely to comply with standards or requirements of any government and expenditures made to restore property as a result of losses arising from fire, storm, or other casualty are not counted towards the 20-percent limitation. Lastly, where a REIT makes a loan under which the debtor is advanced additional monies at different times (such as is typically done in the case of a construction loan), the advance on the loan is not treated as expenditure by the REIT unless default on the loan has become imminent.

With regard to the not more than five sales per year rule, the sale of more than one property to one buyer as part of one transaction is to be treated as one sale. For this purpose, the properties need not be contiguous or located near each other. However, all of the properties sold to the one buyer must be part of the same transaction. In addition, the bill provides that sales where the net selling price (total

selling price less related selling expenses) is less than $10,000 are to be disregarded for purposes of counting the permissible 5 sales per year. If a REIT sells more than five properties under the rule, the safe harbor rule does not apply to the REIT for that taxable year and none of the sales is protected by the safe harbor rule. Any sale or other disposition of property is counted towards this rule (unless excluded under the $10,000 exception) regardless of whether the transaction resulted in a gain or a loss to the REIT.

For purposes of the rental test, any rental of the property at an insignificant rate of rent or for a use which indicates that the purpose of the rental arrangement was not for the production of rental income is to be disregarded. For example, where a REIT holds developed land in order to derive gain from the sale of the property, the property cannot qualify under the safe harbor rule simply by having the REIT rent the property at a rent substantially below the rental rate of comparable property. Similarly, where a REIT holds undeveloped land in order to derive gain from the sale of the property, the property cannot qualify under the safe harbor rule by having the REIT rent the property for a use such as for horseback riding trails or for hunting even though the rent received by the REIT is a fair rent from the property for that use.

The bill also provides that the fact that a sale does not come within the requirements of the safe harbor rule (including transactions occurring before the effective date of the provision) is not to be taken into account in determining whether the sale constitutes a prohibited transaction. Whether or not such a sale constitutes a prohibited transaction is to be determined under the facts and circumstances of each case as if the safe harbor rule had not been enacted. In addition, the mere fact that a sale comes within the safe harbor rule is not to be taken into account in determining whether any gain or loss on the sale is entitled to capital gain treatment.

In addition, the bill would increase the additional period that the IRS may grant to a REIT to hold foreclosure property from two years to four years (for a total of six years that foreclosure property may be held).

Effective date

The provision is effective on the date of enactment.

Revenue effect

This provision will not have any revenue effect.

d. Contributions in aid of construction to regulated electric or gas public utilities (sec. 374 of the bill and sec. 118 of the Code)

Present law

In general

Generally, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation have a zero basis to the corporation. If money is contributed by a nonshareholder, the basis of any prop-

erty acquired with the money during the 12-month period beginning on the date the contribution is received, or of certain other property, is reduced by the amount of the contribution (sec. 362(c)).

Tax treatment prior to the Tax Reform Act of 1976

Early in the development of the Federal income tax laws, there were a number of court decisions which held that customer contributions to public utilities to pay for the costs of extension service lines were to be treated as contributions to capital, and not as income, of the public utility.

In 1958, the Internal Revenue Service announced that it would apply that early case law with respect to contributions in aid of construction, but only with respect to regulated utilities (Rev. Rul. 58–535, 1958–2 C.B. 25). In 1975, the Internal Revenue Service issued Rev. Rul. 75–557 (1975–2 C.B. 38) which revoked the 1958 ruling, withdrew the acquiescences in the early line of cases, and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service were includible in the utility's income. The ruling was made prospective for transactions entered into on or after February 1, 1976.

Tax treatment after the Tax Reform Act of 1976

Generally, the Tax Reform Act of 1976 provided that contributions in aid of construction to regulated public water and sewerage utilities (but not other utilities) are to be treated as nontaxable contributions to capital. However, nontaxable treatment was not provided for customer connection fees. Customer connection fees include payments made by a customer to the utility for the cost of installing the connection between the customer's line and the utility's main water or sewer lines (including the cost of meters and piping) and any amounts paid as service charges for stopping or starting service. In addition, a water or sewerage utility which receives a nontaxable contribution in aid of construction is not entitled to any depreciation deductions or investment tax credits with respect to property acquired with the nontaxable contribution.

A contribution to the capital of a regulated public water or sewerage utility qualifies for nontaxable treatment if it is a contribution in aid of construction under regulations prescribed by the Secretary of the Treasury [1] and if the property contributed, or property acquired with the contribution, is not included in the rate base for rate-making purposes. Where the contribution is in property which is other than water or sewerage disposal facilities, the contribution must be used for

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[1] Proposed regulations under sec. 118 were published May 30, 1978 (43 Fed. Reg. 22997).

[2] A qualified expenditure is an amount which is expended for the acquisition or construction of tangible property described in sec. 1231(b), where the acquisition or construction of the facility was the purpose motivating the contribution. For this purpose, a capital asset includes all expenditures which must be capitalized for such facilities under the normal rules of tax accounting (sec. 263). The assets must be used predominantly (i.e., 80 percent or more) in a trade or business of furnishing water or sewerage services to the utility's customers. Expenditures must be made by the end of the second taxable year after the year in which the money was received.

must be included in income for the taxable year in which received.[3]

The 1976 Act did not affect the treatment of contributions to utilities other than water and sewerage utilities.

Reasons for change

The committee believes that contributions in aid of construction to regulated public gas and electric utilities should be treated as nontaxable receipts in the same manner as contributions made to water and sewerage utilities. Since the imposition of an income tax on contributions in aid of construction reduces a utility's working capital until recovered through higher consumer charges, nontaxable treatment of the contributions will assist a utility in meeting demands for new and increased services. Further, nontaxable treatment would eliminate mismatching of income and expense with respect to contributions in aid of construction which might arise if contributions are fully taxable in the year of receipt and deductions attributable to the expenditure of the contributions are allowable in later years.

Explanation of provision

The bill extends the present law provisions, which are applicable to contributions in aid of construction to water and sewerage utilities, to contributions made to regulated public gas and electric utilities. Thus, contributions in aid of construction received by these utilities will be treated as nontaxable contributions to capital by noneshare holders and not as taxable income to the utility. However, customer connection fees will be treated as taxable income.[4] Also, no depreciation and investment tax credits will be allowable with respect to nontaxable property contributions or property acquired with nontaxable contributions.

A gas transmission utility which provides gas services which are resold to the general public is considered to be a regulated public gas utility for purposes of the provision. Also, contributions in aid of construction of steam facilities are covered by the provision.

In providing special rules for gas and electric utilities, the committee intends that no inference should be drawn as to the proper treatment of contributions in aid of construction to other utilities.

Effective date

The bill applies to contributions made after January 31, 1976.

Revenue effect

If all the contributions in aid of construction to gas and electric utilities were treated as income, the annual increase in tax liabilities is esti-

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[3] Accurate records must be kept of the amounts contributed on the basis of the project for which the contribution was made and by year of contribution.

[4] Under present law, customer connection fees include amounts paid to connect the customer's "property" to a main water or sewer line. The bill revises the statutory language to refer to amounts paid to connect the customer's "line" to a main line. This language change was made to reflect the inclusion of public electric utilities. Thus, it is clear under the bill that, where the main line is located on or under the property of the customer, a customer connection fee does not include amounts for the installation of the main line. However ,a customer connection fee includes amounts for the installation of the connecting line between the main line and the customer's line located in his home (or other place where the customer's ownership of the line begins) regardless of whether that connecting line was located on or under his property or the property of another.

mated to be in the range of $130–200 million. This estimate takes into account the increases in the amounts the utilities would charge to their customers if all the contributions were treated as income to the utilities. It is uncertain when these tax liabilities would first be reflected in higher budgets receipts, however. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Rulings 75–557 were an incorrect interpretation of the law, higher assessments of taxes against the electric and gas utilities probably would not occur until their 1976 tax returns are audited, probably some time during calendar year 1979. Some of these assessments undoubtedly would be contested in court, but some might not. Thus, the first major impact on the budget receipts would very likely be in fiscal year 1980, but the timing of the higher tax payments and the amounts cannot be estimated by fiscal year with any degree of accuracy.

On the other hand, if Revenue Ruling 75–557 were held to be incorrect by court decisions, then the proposal to broaden section 2120 of Public Law 94–455 would have no revenue effect because it could be viewed as codifying the pre-1976 tax treatment of contributions in aid of construction (other than customer connection fees) of regulated utilities.

e. Treatment of certain liabilities on incorporation of a trade or business (sec. 375 of the bill ,and secs. 357(c) and 358(d) of the Code)

Present law

Under present law, no gain or loss generally is recognized for Federal income tax purposes on the transfer of property and associated liabilities to a corporation (usually upon its incorporation) solely in exchange for its stock or securities, where the transferors of such property control the corporation (i.e., own 80 percent or more of the stock) immediately after the exchange (sec. 351). However, gain is recognized to the extent that the sum of the amount of liabilities assumed by the corporation, plus the amount of liabilities to which the property is subject, exceeds the adjusted basis of the property transferred to the corporation (sec. 357(c)).[1]

In recent years, considerable controversy has arisen over the treatment of certain liabilities (such as accounts payable) if assumed by the corporation when property is transferred, upon incorporation or in other generally tax-free asset-for-stock exchanges under section 351, by a taxpayer using the cash-basis accounting method.

Until recently, the United States Tax Court has given the term "liabilities" as used in section 357(c) an all-inclusive meaning.[2] Under this interpretation, a cash-basis taxpayer may be subject to recognition of gain upon incorporation of his or her trade or business. Thus, if the sum of the liabilities (including accounts payable) of a cash-basis taxpayer exceeds the basis of the taxpayer's assets, gain is recognized under section 357(c) even though there were neither tax benefits

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[1] Section 357(c) also applies to reorganizations within the mean of section 368(a)(1)(D).

[2] *Raich* v. *Comm'r*, 46 T.C. 604 (1966); *Thatcher* v. *Comm'r*, 61 T.C. 28 (1973), rev'd in part and aff'd in part, 533 F. 2d 1114 (9th Cir. 1976); *Bongiovanni* v. *Comm'r*, 30 CCH Tax Ct. Mem. 1124 (1971), rev'd 470 F. 2d 921 (2d Cir. 1972).

realized by the transferor on liabilties assumed by the corporation nor withdrawal of borrowed cash through loans made against assets transferred to the corporation prior to the transfer.

Three approaches have been developed by courts to alleviate this problem.

One alternative is that adopted by the Second Circuit in *Bongiovanni* v. *Comm'r*, 470 F. 2d 921 (2d Cir. 1972), holding that the term "liability" for purposes of section 357(c) does not include accounts payable. The Second Circuit stated that:

> "Section 357(c) was meant to apply to what might be called 'tax liabilities', *i.e.*, liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction. * * * The payables of a cash basis taxpayer are 'liabilities' for *accounting* purposes but should not be considered 'liabilities' for *tax* purposes under Section 357(c) until they are paid." 470 F. 2d at 924 (emphasis in original).

The second judicial approach developed is that while no deductions are ordinarily available in section 351 exchanges section 357(c) turns the transaction into an ordinary exchange for the purpose of recognizing gain. Since there is some authority for the proposition that in an ordinary exchange the assumption of liabilities by the purchaser will give the taxpayer an immediate deduction,[3] it was concluded that the transferor should receive a deduction for trade accounts payable discharged by the transferee in the same year as the transfer, to the extent of the accounts receivable or the gain recognized under section 357(c), whichever is less. This approach was suggested in a dissenting opinion by Judge Hall in the *Thatcher* case in the Tax Court, and was, in general, adopted by the Ninth Circuit in reversing the Tax Court's decision on this issue.[4] Under this approach, the deduction is allowed to the transferor only when the transferee corporation pays the assumed liability. Accordingly, it appears that under the Ninth Circuit's approach, the transferor could obtain a deduction on discharge of the transferred accounts payable in a year subsequent to the year of transfer.

Third, the Tax Court last year in the *Focht* case [5] reversed its longstanding position on the treatment of accounts payable under section 357(c). Under the Tax Court's approach, the term "liability" under section 357(c) would be limited to those obligations which, if transferred, cause gain recognition under *Crane* v. *Comm'r*, 331 U.S. 1 (1947), and an obligation would not be treated as a liability to the extent that its payment would have been deductible if made by the transferor. The Tax Court also held in *Focht* that under section 358. deductible liabilities are excluded in determining the transferor's basis in stock received as part of the exchange.

Reasons for change

The ambiguity of present law has resulted in differing judicial interpretations of the term "liabilities," and has in some cases resulted in unforeseen and unintended tax difficulties for certain cash basis tax-

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[3] *James M. Pierce Corp.* v. *Comm'r*, 326 F. 2d 67 (8th Cir. 1964).

[4] *Thatcher* v. *Comm'r*, 61 T.C. 28, 43 (1973) (Hall, J., dissenting), rev'd on this issue, 533 F. 2d 114 (9th Cir. 1976).

[5] *Focht* v. *Comm'r*, 68 T.C. 223 (1977).

payers who incorporate a going business. Although the more recent judicial trend has been to exclude certain deductible liabilities from the scope of sections 357(c) and 358(d), no uniform rationale for that result has been developed by the courts. The committee therefore believes that it is appropriate to resolve the ambiguity as to whether for purposes of sections 357(c) and 358(d) the term liabilities includes deductible liabilities of a cash basis taxpayer.

Explanation of provision

Under the provision bill, in determining (for purposes of section 357(c)) the amount of liabilities assumed or to which the property transferred is subject, the amount of a liability would be excluded for a cash basis transferor to the extent payment thereof by the transferor would have given rise to a deduction or would have constituted certain payments to partners under section 736(a).[6]

However, the amount of any liability excluded under this general rule would be included for purposes of the section 357(c) computation to the extent that the incurrence of such obligation resulted in the creation of, or an increase in, the basis of any property.[7] This provision of the bill essentially would codify the approach taken by the Tax Court in the *Focht* case.

The provision further provides that in determining the transferor's basis in stock received in the exchange, liabilities excluded from the provisions of section 357(c) would not be treated as liabilities assumed or to which property is subject for purposes of section 358(d). This provision of the bill also would codify the approach taken by the Tax Court in *Focht*.

Finally, the provision is not intended to affect the corporate-transferees' tax accounting for the excluded liabilities. It also is not intended to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b).

The House bill does not contain a comparable provision.

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[6] Section 736(a) applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's active interest in the partnership. If such payments meet the requirements of section 736, they are considered either as a distributive share of partnership income to the recipient or as guaranteed payments. If the payments are considered a distributive share of partnership income, than the distributive shares of the other partners are reduced. If payments are guaranteed payments, then they are deductible under section 162 by the partnership.

In either instance, for cash basis taxpayers the obligation to make such payments is similar to the partnership's obligation with respect to its (deductible) accounts payable since both would constitute ordinary deductions or would reduce gross income to the non-retiring partners when the obligations are paid. Accordingly, under the bill, section 736(a) payments would be excluded in determining the amounts of liabilities assumed or to which the property transferred is subject for purposes of section 357(c) and 358(d).

[7] The exception for obligations which give rise to basis would apply for example, where a cash-basis taxpayer purchases small tools on credit and, prior to paying for the tools, transfers them along with the related obligation to a new corporation in a section 351 transaction. While the transferor would have been entitled to a deduction if he had paid off the obligation, pending payment he would have a basis in the tools equal to the amount of the unpaid obligation. Under the provision, that obligation would constitute a "liability" for purposes of section 357(c); but the amount of this liability would be offset by the basis in the transferred tools.

Effective date

The provision applies to transfers of property to corporations made on or after the date of enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

f. Medical expense reimbursement plans (sec. 376 of the bill and sec. 105 of the Code)

Present law

Under present law, gross income does not include amounts received under an accident or health plan for employees as reimbursement for expenses incurred by an employee for the medical care of the employee or the spouse or dependents of the employee unless the expenses were deducted by the employee in a prior taxable year.

Reasons for change

In some cases uninsured medical reimbursement plans have been established by businesses under which the principal beneficiaries are the officers of the company, its major shareholders, and its highest paid workers. These plans can tailor their benefits to fit the particular needs of these employees. Under present law, such a plan can exclude all rank-and-file workers. The committee determined that the tax benefits presently available under uninsured medical reimbursement plans should be continued only for those plans which cover a nondiscriminatory classification of employees.

Explanation of provision

General

Under the bill, nondiscrimination standards will be provided for uninsured medical reimbursement plans provided by employers for employees. The bill will prohibit discrimination in favor of certain employees who are officers, shareholders, or highly compensated. All (or a portion) of benefits paid under a discriminatory plan to employees in whose favor discrimination is prohibited would be included in the gross income of those employees.

Under the bill, a medical reimbursement plan is any plan or arrangement under which an employer reimburses an employee for health or accident expenses incurred by the employee (or a dependent of the employee). The bill applies only to an uninsured medical reimbursement plan, that is, a plan (or a portion of a plan) under which benefits are not provided by a licensed insurance company. Because underwriting considerations generally preclude or effectively limit abuses in insured plans, the committee does not regard the bill as a precedent for the treatment of insured health or accident plans.

Coverage

Under the bill, a medical reimbursement plan will not qualify for favorable tax treatment unless it meets breadth-of-coverage requirements similar to requirements that are applicable to qualified pension plans.

Operation

Under the bill, excludible treatment of reimbursements for key employees is reduced (or eliminated) if the benefits covered by the plan discriminate in favor of key employees. This test is applied to benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan. Under the bill, a plan is discriminatory if it provides greater benefits for key employees than other employees. For example, a plan would be discriminatory if benefits thereunder are in proportion to employee compensation. No advance determination by the Internal Revenue Service as to the tax status of a plan is required.

Key employees

Under the bill, the status of an employee as an officer or shareholder will be determined on the basis of the employee's officer status or stock ownership during the year. However, under the bill, the level of an employee's compensation will be determined on the basis of the employee's compensation for the previous year. For a new employer, the compensation level of an employee for the first and second year of operation would be determined on the basis of the employee's actual rate of compensation during the first year of the employer's operation. Medical reimbursement benefits are not taken into account in determining the level of compensation.

Special rules

Also, in applying the breadth-of-coverage rules and the nondiscriminatory operation rules, benefits provided for an employee under Medicare or other Federal or state law providing for health or accident benefits may be offset against the benefits provided under a medical reimbursement plan.

Treatment of key employees

If a plan fails the breadth-of-coverage rules or the nondiscriminatory rule for a year, then all or a portion of the amount reimbursed to key employees covered by the plan during that year would be includible in their income. Where a benefit is available only to key employees, the includible portion for each key employee is the amount reimbursed to the employee with respect to benefits not available to a broad cross-section of employees. In a case of discriminatory coverage, the includible portion for each key employee is determined by multiplying the amount reimbursed to the employee during the year by a fraction, the numerator of which is the amount reimbursed to key employees under the plan for the year and the denominator of which is the total amount reimbursed under the plan to all employees of the employer for that year.

Effective date

The medical reimbursement plan rules apply for taxable years beginning after December 31, 1979.

Revenue effect

This provision will result in an increase of budget receipts of less than $5 million annually beginning in 1980.

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g. Extension of five-year amortization for low-income rental housing (sec. 377 of the bill and sec. 167(k) of the Code)

Present law

Under the Code, special depreciation rules are provided for expenditures to rehabilitate low-income rental housing (sec. 167(k)). Low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. Occupants of a dwelling unit are considered families and individuals of low or moderate income only if their income does not exceed certain limits, as determined by the Secretary of Treasury in a manner consistent with the limits established for the Leased Housing Program under section 8 of the United States Housing Act of 1937, as amended.

Under the special depreciation rules for low-income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. Under present law, only the aggregate rehabilitation expenditures for any housing which do not exceed $20,000 per dwelling unit qualify for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for 2 consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

Reasons for change

The special tax incentive for rehabilitation expenditures for low- and moderate-income rental housing under present law expires on December 31, 1978. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provision for low-income rental housing should be extended for an additional three years.

Explanation of provision

The bill provides a three-year extension of the special 5-year depreciation rule for expenditures to rehabilitate low-income rental housing. Under the bill, rehabilitation expenditures that are made pursuant to a binding contract entered into before January 1, 1982, would qualify for the 5-year depreciation rule even though the expenditures are actually made after December 31, 1981.

Effective date

The three-year extension applies to expenditures paid or incurred with respect to low- and moderate-income rental housing after December 31, 1978, and before January 1, 1982 (including expenditures made pursuant to a binding contract entered into before January 1, 1982).

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $1 million in 1979, and $7 million in 1980 and $27 million in 1983. Budget receipts will be reduced by $1 million in fiscal year 1979, $4 million in 1980, and $24 million in fiscal year 1983.

h. Postponement of effective date for special limitations on net operating loss carryovers (sec. 378 of the bill and secs. 382 and 383 of the Code)

Present law

Prior to enactment of the Tax Reform Act of 1976, the tax law generally provided that where new owners purchased 50 percent or more of the stock of a loss corporation during a 2-year period, its loss carryovers from prior years were allowed in full if the corporation continued to conduct its prior trade or business or substantially the same kind of business. If the same business was not continued, however, loss carryovers were completely lost. This "purchase" rule applied where one or more of the 10 largest shareholders increased their stock ownership, within a 2-year period, by 50 percentage points or more in a transaction in which the purchasers took a cost basis in their stock (except where the stock was acquired from "related" persons).

In the case of a tax-free reorganization, loss carryovers were allowed on a declining scale. If the former owners of the loss company received 20 percent or more of the fair market value of the stock of the acquiring company, the loss carryovers were allowed in full. For each percentage point less than 20 which the former owners received, the loss carryover was reduced by 5 percentage points. It was immaterial whether the business of the loss company was continued after the reorganization.

The 1976 Act extensively revised the Code provisions dealing with the carryover of net operating losses in cases of acquisitions of loss corporations. The limitations on loss carryover attributes apply to acquisitions made by purchase or through corporate reorganizations. The new provisions change the basic concept underlying the rules by deleting continuity of business requirements for purchases and establishing a new continuity of ownership tests applicable to both purchases and reorganizations.

These new provisions apply to plans of reorganization adopted on or after January 1, 1978, and to sales or exchanges in taxable years beginning after June 30, 1978.

Reasons for change

A number of technical problems regarding the 1976 Act revisions to the net operating loss carryover rules have been brought to the committee's attention which will require consideration of additional revision of the rules.

Explanation of provision

The committee amendment delays for two additional years the effective date of the changes to the limitations on the net operating loss rules made by the 1976 Act. As extended, the 1976 Act provisions will not take effect until January 1, 1980, with respect to plans of reorganization adopted on or after that date, or until June 30, 1980, with respect to sales or exchanges occurring in taxable years beginning after that date.

However, the amendment does permit taxpayers to elect to have the 1976 Act provisions apply to any acquisition or reorganization occurring before the close of the taxpayer's first taxable year beginning

after June 30, 1978, provided such acquisition or reorganization occurs pursuant to a contract or option to acquire stock or assets entered into before September 27, 1978. If a taxpayer makes such an election, it must be made on a timely filed return for its first taxable year in which a reorganization or acquisition to which this section would otherwise apply occurs, or if later within 90 days of the enactment of the Act. The election shall apply to all acquisitions and reorganizations by such taxpayer during the 2-year period in which the effective date would otherwise be postponed. The purpose of this election is to allow taxpayers who relied on the 1976 Act to have it apply to certain transactions.

Effective date

This provision is effective upon enactment.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

i. Redemptions of United States Railway Association certificates of value (sec. 379 of the bill and sec. 374 of the Code)

Present law

On April 1, 1976, eleven insolvent midwestern and northeastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress [1] in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under this legislation, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) will receive ConRail stock and "certificates of value" issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization. A special court will eventually determine the value of these certificates in order to set the amount of compensation the transferror railroads will receive for their properties.

In 1976, the Congress also enacted legislation to deal with the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,[2] the transfer of rail properties to ConRail is treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders do not recognize gain or loss on the transfer and ConRail receives a carryover basis in the properties it acquired.

This legislation also includes rules which allow a transferor railroad's net operating losses eligible for carryover (at the time of the

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[1] The facilities legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

[2] P.L. 94-253, approved March 31, 1976.

transfer of property to ConRail) to be extended beyond the normal expiration date,[3] but only for use by the transferor against any future income arising from awards of the courts and the redemption of certificates of value. Literally, the language of these rules (sec. 374(e)(1)(A)) requires that net operating loss carryovers which are extended may not be applied to income arising from the certificates of value received by any corporation other than the corporation which originally received these certificates.

Reasons for change

Since the committee last considered the tax aspects of the ConRail reorganization in 1976, one situation involving the treatment of the transferor railroads have been brought to its attention.

In this situation, an affiliated group of transferor corporations filed consolidated income tax returns for a number of years preceding the April 1, 1976, ConRail transfer and have sizable consolidated net operating loss carryovers which are eligible for the special extended carryover period. Many of the subsidiaries in this group transferred all of their railroad assets to ConRail and presently holds as their only assets the certificates of value or the right to receive these certificates. The parent corporation would like to simplify the corporate structure by merging or liquidating many of its now nonoperating subsidiaries into other members of the group. However, the language of the existing Code provision would appear to prevent the use of the extended net operating loss carryovers against income from the certificates of value because the surviving corporation which receives the certificates of value in a merger or liquidation would not be the original recipient of the certificates.

Explanation of provision

The bill amends Code section 374(e)(1)(A)(iv) to allow the use of expired net operating loss carryovers against income which is realized from ConRail certificates of value by a member of an affiliated group of corporations (as defined under Code section 1504) where the certificates were originally issued to another corporation which was, on March 31, 1976, (immediately prior to the transfer of assets to ConRail), a member of the same affiliated group.

Effective date

This provision applies to taxable years ending after March 31, 1976.

Revenue effect

This provision will not have any revenue effect.

L. Capital Gains Provisions

1. Capital gains deduction for individuals (sec. 402 of the bill and sec. 1202 of the Code)

Present law

Under present law, a noncorporate taxpayer deducts from gross income 50 percent of the amount of any net capital gain for the taxable year (sec. 1202). The net capital gain equals the excess of net long-

[3] Under present law, the transferor railroads are generally entitled to 5-year carryover periods for these losses.

term capital gains over net short-term capital losses. The remaining 50 percent of the net capital gains is included in gross income and taxed at the otherwise applicable regular tax rates.

Reasons for change

The committee believes that the present level of taxes applicable to capital gains has contributed both to a slower rate of economic growth than that which otherwise might have been anticipated, and also to some taxpayers realizing fewer potential gains than they would have realized if the tax rates had been lower. In some instances, the taxes applicable to capital gains effectively may have locked some taxpayers into their existing investments. Moreover, the committee believes that the present level of capital gains taxes has contributed to the shortage of investment funds needed for capital formation purposes generally, and especially for new and small businesses. As a result, the committee believes that changes are required in the tax provisions applicable to capital gains.

The committee believes that lower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut, and potentially lead to an actual increase in revenues. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue. Six former Secretaries of the Treasury have informed the committee that they believe lower capital gains taxes will raise, not lower, revenues.

The committee recognizes that an increased capital gains deduction will benefit all taxpayers with capital gains, regardless of their respective income levels, and also will have the effect of lowering the capital gains tax rates. On the other hand, merely reducing the maximum tax rate applicable to capital gains would benefit only those individuals whose gains were subject to those rates. The committee, therefore, believes that increasing the deduction, rather than simply lowering rates, is the preferable alternative.

In addition, the committee believes that an increased capital gains deduction will tend to offset the effect of inflation by reducing the amount of gain which is subject to tax. Thus, by increasing the deduction, taxable gain should be reconciled more closely with real, rather than merely inflationary gain. However, since the deduction is constant, unlike the automatic adjustments generally provided for in various indexation proposals, it should not tend to exacerbate inflationary increases.

The committee believes that the increased deduction, in conjunction with the bill's other capital gains tax changes and its reformulation of the minimum tax, should contribute significantly to a more favorable economic climate by increasing the availability of capital, and by providing an incentive for taxpayers to realize gains and increase savings. In addition, the committee's provisions relating to the alternative minimum tax (*see below*) should assure that every individual pays at least a minimum amount of tax.

Explanation of provision

The bill provides that a noncorporate taxpayer may deduct from gross income 70 percent of the amount of any net capital gain for the

taxable year. The remaining 30 percent of the net capital gain is includible in gross income and subject to tax at the otherwise applicable rates. The excluded 70 percent of any gain is classified as a tax preference for purposes of the alternative minimum tax (*see below*), and with respect to post October 1, 1978, gains which are subject to the add-on minimum tax.

The bill does not change the present law treatment of a noncorporate taxpayer's capital losses.

As a transition rule, the bill generally provides that a noncorporate taxpayer may deduct from gross income 70 percent of the post-October, and one-half of the pre-November, capital gains. These rules are intended to make the appropriate differentiation between pre- and post-effective date gains and losses.

The bill also coordinates the increased capital gains deduction with the rules applicable to charitable contributions of property. It provides that the amount of certain charitable contributions of capital gains property is to be reduced by 30, rather than 50, percent of the gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value.

There is no comparable provision in the House bill.

Effective date

The provision is effective for taxable transactions occurring, and for installment payments received, after October 31, 1978.

For a taxable year ending after October 31, 1978 and beginning before November 1, 1978, a transitional rule is provided. Under this rule, the new 70 percent exclusion will apply to the net capital gains in excess of any pre-November capital losses taking into account only sales or exchanges (including short-term transactions) after October 31, 1978. In computing the post-October net gain, no capital loss carryover is taken into account.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $3,394 million in 1979, $3,648 million in 1980, and $4,532 million in 1983. Budget receipts will be reduced by $250 million in fiscal year 1979, $3,394 million in fiscal year 1980, and $4,216 million in fiscal year 1983.

In addition, it is estimated that this provision will increase liabilities due to induced capital gains realizations. Calendar year liabilities will be increased by $1,092 million in 1979, $1,174 million in 1980, and $1,485 million in 1983. Budget receipts will be increased by $85 million in 1979, $1,092 million in 1980, and $1,356 million in 1983.

2. Repeal of alternative tax for capital gains of individuals (sec. 401 of the bill and sec. 1201(b) of the Code)

Present law

Under present law, a noncorporate taxpayer deducts from gross income 50 percent of the amount of any net capital gain for the taxable year (sec. 1202). The remaining 50 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular tax rates.

In lieu of taxing 50 percent of net capital gains at the regular rates, a partial alternative tax of 25 percent on the first $50,000 of net capital gains applies if it results in lower tax rate than that produced by the regular method (sec. 1201(b)).

Reasons for change

Due to the committee's decision to increase the noncorporate capital gains deduction from 50 to 70 percent, the alternative tax no longer results in a lower tax rate for any individual since no taxpayer would pay a regular tax in excess of 21 percent.

Explanation of provision

The bill repeals the noncorporate alternative tax for capital gains. The House bill also repeals the noncorporate alternative tax.

Effective date

This provision is effective for taxable years beginning after October 31, 1978.

Revenue effect

It is estimated that this provision will increase calendar year liabilities by $133 million in 1979, $143 million in 1980, and $178 million in 1983. Budget receipts will be increased by $20 million in fiscal year 1979, $133 million in fiscal year 1980, and $166 in fiscal year 1983.

It is estimated this provision will cause induced capital gains realizations. See estimate given in section 1, above.

3. Corporate alternative tax for capital gains (sec. 403 of the bill and sec. 1201(a) of the Code)

Present law

Under present law, an alternative tax of 30 percent applies to corporate net capital gains (the excess of net long-term capital gain over net short-term capital loss) if that rate is less than its regular tax rate (sec. 1201(a)). No special deduction for any amount of a long-term capital gain is available to corporations.

Reasons for change

The committee believes that a reduction in the corporate alternative tax rate is necessary to provide corporate capital gains with the same tax differential (i.e., 18 percentage points) that it presently enjoys over the maximum regular corporate tax rate, which this bill reduces from 48 percent to 46 percent. The committee also believes that a reduced corporate capital gains tax rate will contribute to an improved economic climate both through an increased corporate ability to provide internal sources of capital, and by making additional funds available for distribution to shareholders.

Explanation of provision

The bill reduces the corporate alternative tax rate from 30 to 28 percent.

There is no comparable provision in the House bill.

Effective date

This provision is effective for sales occurring, and installment payments received, after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $117 million in 1979, $135 million in 1980, and $177 million in 1983. Budget receipts will be reduced by $53 million in fiscal year 1979, $125 million in fiscal year 1980, and $170 million in fiscal year 1983.

For fiscal year taxpayers a transitional rule is provided under which the new rate will apply to the net capital gains for post-December, 1978 sales and exchanges in excess of any pre-January, 1979 capital losses for the year (taking into account capital loss carrybacks but not carry forwards).

4. Exclusion of gain on sale of residence (sec. 404 of the bill and sec. 121 of the Code)

Present law

In general

Under present law, the entire amount of gain or loss realized on the sale or exchange of property generally is recognized. However, under a "rollover" provision of the Code, gain is not recognized on the sale or exchange of a taxpayer's principal residence if a new principal residence, at least equal in cost to the adjusted sales price of the old residence, is purchased and used by the taxpayer as his or her principal residence within a period beginning 18 months before, and ending 18 months after, the date of the sale of the old residence. The basis of the new residence then is reduced by the amount of the gain not recognized on the sale of the old residence. When the purchase price of the new residence is less than the adjusted sales price of the old residence, gain is recognized only to the extent that the adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

If, however, an individual realizes gain on the sale or exchange of a residence and fails to satisfy the rollover requirements, then the gain generally is taxable pursuant to the usual rules of the Code to the extent the exclusion for sales of residences by elderly taxpayers does not apply.

Individuals age 65 and over

Under present law, an individual who has attained the age of 65 may elect to exclude from gross income, on a one-time basis, the entire gain realized on the sale of his or her principal residence if the adjusted sales price is $35,000 or less. If the adjusted sales price exceeds $35,000, the amount excludible is that portion of the gain which is determined by multiplying the total gain by a fraction, the numerator of which is $35,000, and the denominator of which is the adjusted sales price of the residence. The exclusion is not available unless the property was owned and used by the taxpayer as his or her principal residence for 5 years or more during the 8-year period preceding the sale. Due to this actual use and occupancy requirement, the holding period of a condemned or involuntarily converted residence is not added to that of a replacement residence for purposes of having gain on the sale of the latter property qualify for the exclusion.

A taxpayer who has attained the age of 65 may utilize the special exclusion and then use the generally available rollover provision with respect to the balance of any gain.

Reasons for change

The committee believes that the taxes imposed upon an individual with respect to gain that he or she realizes on the sale or exchange of his or her principal residence, in many instances, may be unduly high, especially in view of recent inflation levels and the increasing cost of housing. In most situations, however, the committee believes that the nonrecognition provisions of present law operate adequately to allow individuals to move from one residence to another without recognition of gain or payment of tax. Where an individual either has owned his or her principal residence for a number of years, or has utilized the nonrecognition election of present law, and sells his or her principal residence, either to purchase a smaller, less expensive dwelling, or to move into rental quarters, tax due on the gain realized may be high. While the provisions of present law relating to the exclusion of gain by taxpayers who have attained the age of 65 may ameliorate this situation somewhat, the committee believes that the current dollar limits and age restriction are unrealistic in view of increasing housing costs and decreasing retirement ages. The committee also believes that gain from the sale of a principal residence should not be subject to the minimum tax. In addition, the committee believes that the holding period of a principal residence which is involuntarily converted should be tacked to that of a replacement residence for purposes of meeting the use and occupancy requirements needed to qualify for the exclusion upon a sale of the replacement residence.

Explanation of provision

The bill modifies the provision of present law relating to the exclusion of gain realized on the sale of a principal residence by an individual 65 and over. Generally, the bill extends the availability of the special exclusion provision to all taxpayers, regardless of age, and increases the numerator of the ratio formula from $35,000 to $50,000. It also allows the special exclusion to be used more than once, without reduction in the ratio's numerator, and removes all gain recognized on the sale of a principal residence from the minimum tax. In addition, the bill provides that the holding period of a condemned or involuntarily converted residence may be tacked to that of a replacement residence for purposes of having gain on the sale of the latter property qualify for the exclusion.

The bill's exclusion applies only with respect to gain realized on the sale or exchange of a principal residence which the taxpayer has owned and occupied as his or her principal residence for a period aggregating two years out of the three-year period which immediately precedes the sale. As under present law, the ownership and occupancy rule may be satisfied only by the taxpayer, or by the taxpayer's spouse in the case of married individuals. However, the bill provides two exceptions to the generally applicable ownership and occupancy rule. The first exception is a limited transition rule which provides that individuals who can, or could have, satisfied the age, ownership and use requirements of present law (5 years or more out of the 8-year period

which precedes the sale) will have until July 27, 1981, to qualify for the exclusion either under the new ownership and occupancy test or that of the present law. The numerator of the ratio formula, however, would be $50,000. The second exception provides that the holding period of a condemned or involuntarily converted residence may be tacked to that of a replacement residence for purposes of having gain on the sale of the latter property qualify for the exclusion. In all other instances the actual use and occupancy requirements must be satisfied. Thus, only that period of time which the particular principal residence which is being sold or exchanged was owned and occupied by the taxpayer will be taken into account. The holding period for an old residence will not be taken into consideration even if gain on that residence's sale had been rolled over into the new principal residence which is being sold.

For purposes of the exclusion contained in the committee's bill, the definition of a taxpayer's principal residence is that presently utilized in section 1034, rather than that currently contained in section 121. Therefore, whether property qualifies as an individual's principal residence, or what portion of a large property qualifies, will depend upon the facts and circumstances in each case. Similarly, the facts and circumstances test is to apply to determine which residence is a taxpayer's principal residence where he or she has owned and occupied more than one residence for the two year period preceding the sale in question. The provision also applies to condominiums and to stock of a tenant-shareholder of a cooperative housing corporation.

If an individual realizes gain in excess of the amount excludible under the committee's bill, the taxpayer's gain is to be reduced prior to the application of the section 1202 deduction. Therefore, only 30 percent of the individual's capital gain in excess of the amount excludible under the committee's bill would be includible in the taxpayer's income.

The bill also provides, in the case of an individual who has attained the age of 65, that both the exclusion ratio and the nonrecognition provisions of sections 1033 and 1034 may be used with respect to gain realized on the sale of a principal residence. As under present law, the amount that would have to be reinvested in a new principal residence would be reduced by the amount excluded from income. The balance of any gain not excluded or reinvested then would be reduced by the section 1202 deduction.

The bill does not allow the dual use of the exclusion ratio and the rollover provision in the case of individuals who have not attained the age of 65. Thus, these homeowners either may elect to use the exclusion ratio formula or may use the rollover provision.

If a taxpayer makes an election to exclude gain realized on the sale of his or her principal residence, and subsequently purchases a new residence, the amount of any gain excluded on the prior sale will not reduce his or her basis for the new residence.

The committee's bill also provides that no amount of any gain realized on the sale or exchange of an individual's principal residence, whether or not excludable under the bill, is a tax preference subject to the minimum tax, or to the alternative minimum tax. For this purpose, the definition of a taxpayer's principal residence is that utilized

in section 1034. Gain recognized on the sale of a residence which is not the taxpayer's principal residence remains an item of tax preference.

There is no limitation on the number of times that a taxpayer may use the exclusion ratio provision for gain from a qualifying sale. Moreover, a taxpayer who previously elected to use the one-time $35,000 exclusion ratio provision available to individuals 65 or over also may qualify to use the new election. The election contained in the committee's bill must be made in accordance with regulations prescribed by the Secretary.

The House bill provides a one-time exclusion for $100,000 of gain recognized on the sale of a taxpayer's principal residence, and would repeal the provision of present law relating to sales of a principal residence by an individual who has attained the age of 65.

Effective date

This provision is effective for sales and exchanges after July 26, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $295 million in 1979, $325 million in 1980, and $432 million in 1983. Budget receipts will be reduced by $138 million in fiscal year 1979, $295 million in fiscal year 1980, and $393 million in fiscal year 1983.

5. Rollover of gain on sale of residence (sec. 405 of the bill and sec. 1034 of the Code)

Present law

Prior to the Tax Reduction Act of 1975, gain realized from the sale of property used by the taxpayer as his or her principal residence ("old residence") generally was not recognized where the taxpayer purchased and used property as his or her principal residence ("new residence"),[1] within a period beginning 12 months before, and ending 12 months after, the sale. In determining a taxpayer's new residence, where he or she purchased more than one property which was used as a principal residence during the 24-month replacement period, only the last principal residence used by the taxpayer constituted a "new residence."

This nonrecognition treatment was available, however, only once during any 12-month period. Thus, where the nonrecognition treatment applied to the sale of a taxpayer's residence, it would not apply again for a period ending one year from the date of the sale of the old residence.

The 1975 Act extended the replacement time period for the purchase of a new residence to the period beginning 18 months before the sale of the old residence and ending 18 months after such sale. The 1975 Act also applied the 18-month period in determining which residence was the replacement residence where more than one residence was used by the taxpayer as a principal residence after the sale of the old

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[1] Under section 1034, gain is recognized only to the extent that the adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

residence, i.e., the last principal residence so used during the 18-month period is the "new residence." Accordingly, gain from a second sale of a residence during the 18-month period is not eligible for nonrecognition treatment under the rollover provision if another principal residence subsequently is used by the taxpayer as a principal residence during that period.[2]

Reasons for change

Present law has resulted in hardship for certain individuals who have had to relocate more than once during any 18-month period. The hardship results, in part, from the impact of inflation on the value of homes, and, in part, from the unavailability of the rollover provision where more than one principal residence is purchased and sold within the 18-month statutory period. In such situations large gains may be realized even though a house is held by the taxpayer for less than 18 months. The committee believes that the present 18-month limitation may be too restrictive in light of the fact that employees and self-employed individuals frequently may be required to change employment locations.

Explanation of provision

The bill generally provides for the rollover of gain realized on the sale of more than one principal residence where an individual relocates for employment purposes more than once within a period beginning 18 months from the time that his or her first principal residence is sold. Taxpayers generally will be allowed the benefits of this multiple rollover provision where there was a reasonable expectation at the time of the relocation that the taxpayer would be employed, or remain, at the new location for a substantial period of time.

Thus, where the taxpayer is entitled to deduct moving expenses with respect to a relocation falling within the 18-month period, the 18-month limitation of present law generally would not apply. In such a situation, the multiple rollover provision would be available so as to allow the nonrecognition of gain on the sale of a principal residence occupied by the taxpayer if, in fact, the taxpayer subsequently relocated within the 18-month period for employment purposes and acquired a new principal residence. However, in order to qualify for such treatment, a sale must be in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work and the taxpayer must satisfy both the geographic and length of employment requirements for de-

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[2] The operation of the present law can be illustrated by the following example: A taxpayer sells an old residence on January 15, 1976, and purchases a new residence on February 15, 1976. In March 1977, the taxpayer's employer permanently transfers him or her to a new principal place of work approximately 1,000 miles from the taxpayer's former principal place of work and former principal residence. On April 15, 1977, the taxpayer sells his or her new residence purchased on February 15, 1976. On May 15, 1977, the taxpayer purchases a second new residence at his new principal place of work, and still is residing in the second new residence on July 15, 1977. Under present law, the taxpayer's new residence, for purposes of the rollover of gain, is the principal residence purchased on May 15, 1977. Thus, under present law, the taxpayer would recognize no gain on the January 15, 1976 sale, but would recognize gain (long term capital gain) on the April 15, 1977, sale because of the operation of the 18-month limitation provision.

ductibility of moving expenses (secs. 217(c) and 217(d)).[3] In applying the moving expense test to a residence sold within the 18-month limitation period, the residence sold is treated as the "former residence".

In addition, a sale which meets the requirements of the bill will be treated as terminating the 18-month period and starting another 18-month period. Thus, the personal residence receiving rollover treatment under the bill will constitute a new residence with respect to the prior rollover sale and an old residence for purposes of its sale.

Where the multiple rollover provision applies, the basis of each succeeding residence is to be reduced by the amount of gain not recognized on the sale of the prior residence.

The House bill is identical.

Effective date

This provision is effective for sales and exchanges of personal residences after July 26, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $3 million in 1979, $3 million in 1980, and $3 million in 1983. Budget receipts will be reduced by $2 million in fiscal year 1979, $3 million in fiscal year 1980, and $ million in fiscal year 1983.

M. Minimum and Maximum Tax Provisions

1. Alternative minimum tax on individuals (secs. 421 and 422 of the bill and secs. 55–58 of the Code)

Present law

Present law (sec. 56 of the Code) provides a minimum tax on certain tax preferences of individuals and corporations. The minimum tax for individuals amounts to 15 percent of the sum of an individual's (or estate or trust's) tax preferences in excess of one-half of regular income taxes paid or, if greater, $10,000.

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[3] The operation of the provision is illustrated by the following example:

A taxpayer sells his old residence on January 15, 1978, and purchases a new residence on February 15, 1978. In July 1978, taxpayer's employer permanently transfers him or her to a new principal place of work 1,000 miles from the taxpayer's former principal place of work and former principal residence. On August 15, 1978, taxpayer sells his new residence purchased February 15, 1978. On September 1, 1978, taxpayer purchases and uses a second new residence at his new principal place of work. Since the August 15, 1978, sale occurred within 18 months of the January 15, 1978 sale, the 18-month limitation provision of section 1034(d) would in general apply. However, since the August 15, 1978 sale was in connection with the commencement of work by the taxpayer as an employee in a new principal place of work and since the taxpayer satisfies the conditions of section 217(c), the 18-month limitation would not apply to the August 15 sale, and the taxpayer would be eligible for nonrecognition treatment on that sale. In addition, that sale is treated as the last sale in one 18-month period and the first sale in the next 18-month period. Thus, the residence sold August 15 is treated as the last new residence used within the "18-month" period following the January 15, 1978, sale of the taxpayer's old residence, and as an old residence for purposes of the running of the next 18-month limitation period.

If, however, the taxpayer's transfer to a new principal place of work was a temporary transfer which he reasonably could have expected to last only 26 weeks, the provisions of the bill would be inapplicable and the gain realized on the August 15, 1978, sale would be recognized.

The tax preference items included in this base of the minimum tax for individuals are:

(1) Accelerated depreciation on real property in excess of straight-line depreciation;

(2) Accelerated depreciation on personal property subject to a lease in excess of straight-line depreciation;

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));

(4) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167);

(5) Qualified stock options (the excess of the fair market value at the time of exercise over the option price);

(6) Percentage depletion in excess of the adjusted basis of the property;

(7) The deduction for long-term capital gains;

(8) Amortization of child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec. 167));

(9) Itemized deductions (other than medical and casualty loss deductions) in excess of 60 percent of adjusted gross income; and

(10) Intangible drilling costs on oil and gas wells in excess of the amount amortizable with respect to those costs and, for 1977, in excess of net income from oil and gas production.

These items of tax preference also reduce, on a dollar-for-dollar basis, the amount of earned income eligible for the 50-percent maximum tax.

Reasons for change

It is the conclusion of the committee that the present law add-on minimum tax does not serve well either the goal of tax equity or the goal of encouraging capital formation and economic growth by means of tax incentives. Because the tax does not fully depend on the amount of regular taxes paid by the individual, the present minimum tax can result in a substantial tax increase for individuals already paying regular taxes at high rates. For these taxpayers the incentive to invest in capital gain assets as well as other types of investments eligible for preferential tax treatment is significantly reduced. Moreover, because the minimum tax rate is only 15 percent, taxpayers with very substantial amounts of preferences who pay little or no regular tax are paying taxes at effective rates of less than the lowest rate bracket (14 percent) applicable to individuals generally.

For these reasons the committee has agreed to an alternative minimum tax, which is to be paid by the taxpayer only to the extent the tax exceeds a taxpayer's regular tax liability. The minimum tax rates are to be increased to a maximum of 25 percent for those with incomes (including preferences) exceeding $100,000. Thus, taxpayers paying high regular taxes (i.e., approaching or in excess of 25 percent of very large incomes) will not be subject to any minimum tax and thus will have no disincentive for making capital gain producing and other preferentially treated investments. However, the provision will insure that those high income individuals currently paying low regu-

lar taxes because of preferences will in the future pay a substantial amount of tax—approaching 25 percent of their income including preferences.

Explanation of provisions

In general

The bill repeals the present law minimum tax for individuals beginning in 1979 and establishes an alternative minimum tax, under which a taxpayer pays the alternative minimum tax only where it exceeds the taxpayer's regular income tax.

Generally, the tax base for the alternative minimum tax is a taxpayer's taxable income plus the taxpayer's tax preferences for the year. This amount is then reduced by a $20,000 exemption and subject to the following minimum tax rates:

	Percent
0–$40,000	10
$40–$80,000	20
over $80,000	25

The amount of minimum tax is the amount by which the tax computed under this rate schedule exceeds the taxpayer's regular tax. Thus, although the tax is in effect a true alternative tax, in the sense that it is paid only when the amount of tax computed under the above schedule exceeds regular tax, technically the taxpayer's regular tax continues to be imposed and the amount of alternative minimum tax is the *excess* of the amount computed under the minimum tax rate table over the amount of the regular tax.

The provision then allows a foreign tax credit and the refundable credits against this tax is the amount in excess of the taxpayer's regular tax.

Preferences

In general the preferences for purposes of the new alternative minimum tax are the same as under present law. The preference for excluded gain from the sale or exchange of a capital asset is amended to conform to the increased exclusion provided in section 401 of the committee bill. Thus, the capital gain preference for individuals under the bill is 70 percent of net capital gain for the taxable year, i.e., the amount of a taxpayer's capital gain deduction under sec. 1202 of the Code. (This change in the capital gains preference is also made with respect to the increased deduction provided for gains from sales or exchanges occurring in November and December 1978, which is treated as a preference under the present law minimum tax.) Also, gain from the sale of principal residences is not included as a preference under the alternative minimum tax (or under the add-on minimum tax for sales in November or December 1978).

In addition, the bill makes permanent the preference for intangible drilling costs in excess of oil income as modified by the Tax Reduction and Simplification Act of 1977 and as agreed to by both the House and Senate in their versions of the energy tax legislation of this Congress. Under the amendment intangible drilling cost deductions for oil or gas wells would be included in the minimum tax base of individuals only to the extent that intangible drilling and develop-

ment costs, over the amount of those costs amortizable on the basis of a 10-year life or under cost depletion, exceed the taxpayer's income from oil and gas properties. Income from oil and gas properties is to be determined first with reference to the rules for determining gross income from oil and gas properties for purposes of percentage depletion (sec. 613(a) of the Code, without regard to the limitations under sec. 613A). Net income from oil and gas properties is gross income from oil and gas properties reduced by the amount of deductions properly attributable to that gross income (and deductions attributable to oil and gas properties with no gross income), except that no reduction is to be made for those intangible drilling costs subject to the minimum tax (i.e., those incurred on successful wells).

In addition, the bill significantly modifies the preference for adjusted itemized deductions. Under the bill itemized deductions subject to the preference would exclude medical and casualty deductions (as under present law) plus State and local tax deductions and, in the case of income in respect of decedents, amounts deducted (under sec. 691(c)) for estate taxes. The remaining itemized deductions are prefences to the extent they exceed sixty percent of adjusted gross income minus the medical and casualty deductions, State and local taxes and the estate tax described above. Thus, for example, a taxpayer with AGI of $50,000 and total itemized dedutcions of $45,000 (including $10,000 State and local taxes and no medical or casualty expenses) would have $35,000 deductions subject to the preference computation. The amount of the preference would equal the excess of these deductions over 60 percent of the difference between $50,000 and $10,000, or $24,000. Thus, the preference is $35,000 minus $24,000, or $11,000.

Because the alternative minimum tax as contained in the committee bill can substantially reduce the benefit of any preference items to individuals, the provision contains two special elections to allow taxpayers to avoid claiming an item of tax preference to reduce their regular tax. First, the bill allows a taxpayer, in the manner prescribed by the Secretary, to elect to capitalize intangible drilling costs with respect to any oil and gas property. The new election once made with respect to a property cannot be revoked for that property without permission of the Secretary. This property by property election replaces the election under present law which once made by a taxpayer applies for all oil and gas properties for all years of that taxpayer. Second, the bill includes a provision allowing any recipient of a stock option which continues to meet the requirements for preferential treatment (provided in secs. 422 or 424 of the Code) under transitional rules provided in the 1976 Tax Reform Act to be treated as nonqualified options and taxed under section 83 of the Code. Thus, an electing taxpayer would generally recognize income in the year the option is exercised equal to the difference between the fair market value of the stock on the date of exercise of the option and the price paid for the stock (and the employer would receive a corresponding deduction). In this case the taxpayer would not have a stock option preference for purposes of the alternative minimum tax. The election is to be made in the manner prescribed in regulations by the Treasury Department.

Finally, the provision adopts a modified version of an amendment proposed in H.R. 6715 (sec. 2(b)(3) of that bill) so that certain chari-

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table lead trusts which received transfers of property prior to January 1, 1977, would not be subject to the preference for adjusted itemized deductions for contributions attributed to that property.

Minimum taxable income

The amount of income subject to the alternative minimum tax is gross income reduced by all deductions (other than any net operating loss deduction) and by any nonpreferential net operating loss and increased by the amount of tax preferences. This net amount, reduced by a $20,000 exemption is subject to the alternative minimum tax rates described above.[1] Thus, disregarding any net operating losses carried over from other years, a taxpayer can compute his minimum taxable income by adding to his taxable income (including a negative amount where the taxpayer's deductions (including itemized deductions) exceed gross income) the amount of preferences for the taxable year. This method of computation operates as an automatic tax benefit rule in that preferences which produce no regular tax benefit but merely increase a taxpayer's negative taxable income will not, when added back to taxable income, result in any alternative minimum taxable income. Only to the extent that preferences reduce income which otherwise would be subject to regular income tax will any alternative minimum taxable income result.

Regular tax offset

The alternative minimum tax is paid only to the extent that the tax exceeds an individual's regular tax. A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code other than the alternative minimum tax and the penalty taxes applicable in certain circumstances for annuities (sec. 72(m)(5)), lump-sum distributions from qualified pension plans (sec. 402(e)) and individual retirement accounts (sec. 408(f)). These taxes are to be reduced by all nonrefundable credits including the foreign tax credit (sec. 33). Thus taxpayers paying the alternative minimum tax are not to obtain the benefit of nonrefundable credits other than the foreign tax credit to the extent of that taxpayer's alternative minimum tax. However, the bill provides that in the case of the investment tax credit, the WIN credit, and the targeted jobs tax credit (provided in sec. 321 of this bill) any credit carryovers to future years from a year in which the taxpayer is liable for some amount of alternative minimum tax are not to be reduced to the extent of the taxpayer's alternative minimum tax liability. For example, if a taxpayer has a regular tax liability before credits of $10,000, investment tax credits of $5,000 and alternative minimum tax before regular tax offset of $8,000, the taxpayer will pay a tax of $8,000 (consisting of regular tax of $5,000 and alternative minimum tax of $3,000). In this case the taxpayer has used up all $5,000 of investment tax credits against regular tax but has received a benefit only from $2,000 of credits. Thus, the remaining $3,000 of credit for which no tax reduction was obtained is to be available as an additional carryover to the

[1] The rate brackets are reduced by one-half for married individuals filing separate returns. Thus, for these individuals the minimum tax rates are 0–$20,000—10 percent; $20–$40,000—20 percent; and over $40,000—25 percent.

next year to which the credit would be carried over under the usual rules if the credit would not otherwise expire.[2]

Foreign tax credit

The foreign tax credit is to be allowed against the alternative minimum tax. Under the provision the amount of credit allowed is to be determined under the normal foreign tax credit limitation rules (sec. 904), but the computation of the limit is to be modified to include preference items which are added back in computing income subject to minimum tax. Thus, a taxpayer's foreign source income on which foreign tax credits are allowed is to be increased by any preference attributable to foreign sources (or, in the case of deduction preferences, those properly allocated or apportioned to foreign source income) and a taxpayer's entire taxable income is to be increased by all preferences.

Foreign taxes are taken separately as a credit against the alternative minimum tax. Since, for purposes of computing the alternative minimum tax, the regular tax is the tax after allowable foreign tax credits, certain adjustments are necessary to insure that the taxpayer does not lose the benefit of the foreign tax credit taken against the regular tax to the extent that it results in an increase in the alternative minimum tax. The credit is taken against the alternative minimum tax, but the limiation is computed with respect to the portion of the gross alternative minimum tax (i.e., before the regular tax offset) that is attributable to foreign source income. In addition, the amount of foreign taxes paid by the taxpayer for the year is increased by the lesser of an amount equal to the foreign tax credit taken against the regular tax or the amount of the alternative minimum tax for the year. Finally, for purposes of determining the amount of foreign taxes which can be carried as credits to a preceding or succeeding year, the amount of the foreign taxes paid during the year which exceed the regular foreign tax credit limitation are to be reduced by the amount of the foreign taxes taken against the alternative minimum tax.

These rules may be illustrated by the following example of a taxpayer with a capital gain of $100,000, half from domestic sources and half from foreign sources, and other foreign source taxable income of $10,000. Thus, his total taxable income is $40,000, $25,000 of which is foreign source and $15,000 of which is U.S. source. Assume that the taxpayer has paid $15,000 of foreign tax during the year and his regular tax before the foreign tax credit is $10,000. The limitation for purposes of computing the foreign tax credit against the regular tax would be $6,250 ($10,000 times $25,000/$49,000) and the regular tax after foreign tax credits would be $3,750. The taxpayer's alternative minimum tax before the regular tax offset would be $14,500 on alternative minimum taxable income of $110,000, and, after the regular tax offset of $3,750, the alternative minimum tax would be $10,750. For purposes of computing the credit against the alternative minimum tax, foreign

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[2] Where the amount of credits from which no benefit is obtained involves more than one tax credit, the additional credit allowed as a carryover is first to be allocated to the credit which is taken last under the normal Code rules. Thus, any additional credit is first allocated to the targeted jobs credit (to the extent that any credits arose in that year), then to the WIN credit, and finally to the investment tax credit.

taxes paid would be increased by $6,250, which is the lesser of the alternative minimum tax or the foreign tax credit taken against the regular tax. The credit would be limited to $7,909. This is computed by multiplying $14,500 (which is the sum of the alternative minimum tax of $10,750 and the regular tax of $3,750) by a fraction the numerator of which is the alternative minimum taxable income from foreign sources ($60,000) and the denominator of which is the entire alternative taxable income ($110,000). Thus, the $14,500 alternative minimum tax would be reduced by a foreign tax credit of $7,909 to $6,591. The excess credits that may be carried to another year would be $7,091—the excess of $21,250, which is the sum of the foreign taxes paid during the year ($15,000) and the additional foreign taxes deemed paid under this section ($6,250) over $14,159, which is the sum of the regular foreign tax credit limitation ($6,250) and the alternative minimum tax foreign tax credit limitation ($7,909).

Net operating losses

The provision adopts special rules for net operating losses which apply where a net operating loss deduction in any year consists in whole or in part of items of tax preference which added to or created a net operating loss in the year from which the loss is carried.

Under these rules a taxpayer's income for alternative minimum tax purposes is to be reduced by net operating loss deductions only to the extent of the taxpayer's "nonpreferential net operating loss deduction," which is defined as the net operating loss deduction computed without regard to items of tax preference included in that deduction. Thus, a taxpayer is allowed to reduce income subject to the new alternative minimum tax only by any net operating loss deduction to the extent of nonpreference losses making up the deduction.

In determining the extent to which a net operating loss deduction in any year consists of preference items, the bill provides that where deductions are used to offset income in the year the loss producing the net operating loss deduction arises (and when the net operating loss deduction itself is partially used in prior years), the deductions are first to be treated as resulting from any nonpreferential deductions of the taxpayer. For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses of which $10,000 are preference items, the net operating loss for the year is $15,000 out of which $5,000 is nonpreferential net operating loss. Thus, in any subsequent (or prior) year the taxpayer's $5,000 of net operating loss deduction attributable to nonpreference losses will be treated as a nonpreferential net operating loss deduction and be allowed to reduce income subject to the alternative minimum tax as well as income subject to the regular tax. However, to the extent that the taxpayer in any year is allowed against regular tax a net operating loss deduction (attributable to this loss) beyond this $5,000, that amount will be treated as a preferential net operating loss and will not be allowed to reduce income subject to the alternative minimum tax in that year. In effect, that amount is thus treated as a preference in that subsequent year rather than in the year the deduction was taken.

Trusts

The provision also includes special rules for the application of the alternative minimum tax in the case of trusts. First, the $20,000

exemption from the tax is not allowed in the case of trusts. Second, in the case of a trust making current distributions tax preferences which are items of deductions other than depletion and depreciation (e.g., intangible drilling costs) are to be allocated to beneficiaries where appropriate under regulations prescribed by the Secretary. (Of course, a trust is to receive the same deduction for alternative minimum tax purposes for the amount of income currently distributed as is received for regular tax purposes.)

Finally, in the case of accumulation distributions from a trust, the amount of taxes deemed imposed on the trust is not to be increased by any alternative minimum tax in excess of the trust's regular tax liability. Thus, no credit is available to any beneficiary of an accumulation distribution for any minimum tax paid by the trust with respect to that distribution; however, under the normal trust rules, no amount received by that beneficiary is treated as an item of tax preference to the beneficiary.

Effective date

In general the provision is effective for taxable years beginning after 1978. In addition, the provision is not to be treated as a change of the rate of tax (under sec. 21 of the Code). Thus, fiscal year taxpayers are to first be subject to the new minimum tax for their taxable year beginning in 1979.

However, the provisions changing the effective date for the preferences for capital gains (to 70 percent of net capital gain) for purposes of the present law minimum tax is to apply for all sales or exchanges taking place after October 31, 1978.

For purposes of both effective dates payments received after the effective date with respect to pre-effective date installment sales are to be taxed under the new provisions applicable generally to sales made after the effective date.

Revenue effect

It is estimated that this provision will increase calendar year liabilities by $37 million in 1979, $41 million in 1980, and $55 million in 1983. Budget receipts will be increased by $37 million in fiscal year 1980, and $50 million in fiscal year 1983.

It is estimated this provision will cause induced capital gains realizations. See part L, section 1 for estimate.

2. Maximum tax changes (secs. 431 and 432 of the bill and sec. 1348 of the Code)

Present law

Under present law the maximum marginal tax rate on taxable income for personal services is 50 percent. Income from personal services includes wages, salaries, professional fees and other compensation for personal services. In the case of an individual engaged in a trade or business where both personal services and capital are material income producing factors, a reasonable allowance for personal services is treated as personal service income but the amount cannot exceed 30 percent of the income from the business.

The amount of personal service income eligible for the maximum tax is reduced dollar-for-dollar by the amount of tax preferences of the taxpayer for the taxable year, including capital gains.

Reasons for change

The committee believes that the provision reducing income eligible for the maximum tax by amounts of capital gains treated as a minimum tax preference can act as a serious obstacle to productive investment. For example, for a 70-percent bracket taxpayer receiving benefits from the maximum tax on earned income, this provision can increase the taxpayer's effective tax rate on capital gains by 10 percentage points.

In certain situations the 30-percent net profits limitations unfairly treats individuals who conduct their businesses as sole proprietorships or partnerships by imposing a greater tax burden on them then is imposed on an individual who conducts the identical business in corporate form. This tends to encourage individuals to adopt the corporate form of business for no other reason than tax savings. Also, the 30-percent net profits test often times raises difficult questions as to what is the net profits of the business.

Explanation of provisions

The bill makes two changes in the maximum tax. First, any capital gains preference under the minimum tax is not to reduce an inidividual's benefits under the maximum tax. However, other tax preferences are to continue to reduce maximum tax benefits in the same manner as under present law (whether or not the taxpayer is paying any minimum tax).

In addition, the bill removes the 30-percent limitation on the amount of income from a trade or business that can be treated as personal services income where capital is an income-producing factor. Instead, individual taxpayers would receive the benefits of the 50-percent maximum tax on earned income only for income that constitutes a reasonable compensation for the services they actually render whether or not they conduct their businesses in corporate form. In making this determination, the reasonable compensation paid for personal services actually rendered would be allowed. However, an individual would not be permitted to convert into personal service income passive income on investments or assets held or used in a trade or business. Whether there has been such a conversion of passive income to personal service income must be determined by reference to all the facts of each case. For example, a sole proprietor of a small manufacturing business cannot treat dividend and interest income received on investments held by him as personal service income. If passive income is derived from investments held by a trade or business, expenses of the trade or business must be allocated between such passive income and the income available for payment as personal service income.

Effective date

The elimination of the capital gains preference offset from the maximum tax provision applies to gains from sales or exchanges occurring after October 31, 1978.

The modification of the definition of personal services income applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $108 million in 1979, $122 million in 1980, and $175 million in

1983. Budget receipts will be reduced by $271 million in fiscal year 1979, $111 million in fiscal year 1980, and $160 million in fiscal year 1983.

It is estimated this provision will cause induced capital gains realizations. See part L, section 1 for estimates.

N. Other Tax Provisions

1. Employment tax status of independent contractors and employees (sec. 501 of the bill and secs. 3102, 3121, 3306, and 3401 of the Code)

Present law

With certain limited statutory exceptions, the classification of particular workers or classes of workers as employees or independent contractors (self-employed persons), for purposes of Federal employment taxes, must be made under common law rules. A determination of an employer-employee relationship is important because a certain amount of wages paid to employees generally is subject to Social Security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). On the other hand, payments to independent contractors are subject to the tax on self-employment income (SECA). In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

Generally, the basis for determining whether a particular worker is an employee or independent contractor is the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee is deemed to exist. On the other hand, the absence of a right to control generally indicates that the person performing the services is an independent contractor. In interpreting the Treasury regulations, twenty factors are used in determining whether workers are employees or independent contractors.

Reasons for change

In the late 1960s, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification, the taxpayer became liable for employment taxes—withholding, social security, and unemployment—which neither had been withheld nor paid to the Treasury.

In some cases, the assessments were for liabilities already paid directly by workers, who paid their own income and self-employment taxes. The IRS has agreed to allow taxpayers certain income tax and FICA–SECA offsets, if they provide the Service with their workers'

names and social security numbers. However, many taxpayers lack such information about their workers and cannot benefit from this procedure.

Many taxpayers have complained that proposed reclassifications involve a change of position by the Internal Revenue Service in interpreting how the common law rules apply to their workers or industry. Some taxpayers have prior private letter rulings or technical advice memoranda from the Service in which the Service said that the workers were independent contractors. Other taxpayers have pointed to prior audits in which their treatment of workers as independent contractors was not challenged. Before the 1970s, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published Revenue Rulings.

During the 1976 Tax Reform Act conference, House and Senate conferees included in the Statement of Managers a request that the IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent contractors.

The committee believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.

Explanation of provision

The bill prohibits the Internal Revenue Service from applying any changed position or any newly stated position, which is inconsistent with a general audit position in effect on January 1, 1976, in determining whether an individual is an employee for purposes of Federal income tax withholding, Social Security (FICA) taxes and unemployment (FUTA) taxes. The bill also prohibits the Service from applying any changed or newly stated position which is inconsistent with a regulation or ruling in effect on December 31, 1975. The restriction with respect to new or changed IRS positions under a ruling applies not only to published Revenue Rulings of general application with precedential status but also to technical advice, letter rulings and determination letters with respect to a particular taxpayer.

In addition, the bill prevents the Internal Revenue Service from reclassifying certain individuals as employees for purposes of Federal income tax withholding, Social Security taxes and unemployment taxes. Individuals (or classes of individuals) who may not be reclassified are those whom the taxpayer consistently has treated in good faith as independent contractors for employment tax purposes. The taxpayer shall be deemed to have acted in good faith only if all Federal tax returns (including information returns) required to be filed by the taxpayer were filed on a basis consistent with the taxpayer's treatment of such individuals as independent contractors and the taxpayer treated such individuals as independent contractors in reasonable reliance under one or more of four tests. The four statutory bases for

reasonable reliance are: (1) past Internal Revenue Service audit practice with respect to the taxpayer; (2) published rulings or judicial precedent; (3) recognized practice in the industry of which the taxpayer is a member; or (4) long-standing treatment by the taxpayer of such individual or class of individuals for employment tax purposes.

However, a taxpayer will not be considered to have acted in good faith if his treatment of individuals as independent contractors would, on the basis of the pertinent facts and circumstances, constitute negligence, intentional disregard of rules and regulations, or fraud within the meaning of section 6653 of the Code.

The provisions of the bill apply with respect to the determination of the employment status of individuals for all calendar quarters for which, as of the date of enactment of the bill, an assessment of an underpayment of employment tax, or a refund of an overpayment of employment taxes under chapters 21, 23 and 24 of the Code, is not barred by the operation of any law or rule of law. The provisions of the bill will remain in effect until the end of the calendar year in which Congress enacts legislation terminating these provisions prospectively.

The House bill has no comparable provision.

Effective date

This provision is effective upon enactment.

Revenue effect

The revenue effect of this provision cannot be estimated because the provision affects IRS asserted employment tax liabilities which are being contested by taxpayers in both administrative and judicial proceedings.

2. Reporting requirements with respect to charged tips (sec. 502 of the bill and secs. 6041 and 6001 of the Code)

Present law

Present law (sec. 6053(a) of the Internal Revenue Code) requires an employee to report to his or her employer the tips received by the employee, if exceeding $20 in a month, by the tenth day of the following month. The Internal Revenue Service has ruled that this reporting requirement applies with respect to both tips paid directly in cash by customers and also tips added to a waiter's check by a charge customer and paid over to the waiter by the employer (Rev. Rul. 75–400, 1975–2 C.B. 464, as modified by Rev. Rul. 76–231, 1976–1 C.B. 378). Under these rulings, the tips required to be so reported by employees are tips received and retained after any tip-splitting, such as by waiters with busboys, or tip-pooling, such as by a waitress with other waitresses.

Section 6051(a) requires employers to report on IRS Forms W–2, as wages subject to income tax withholding and Federal Insurance Contributions Act (social security) withholding, only the tips actually reported to them by their employees pursuant to section 6053(a).[1]

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[1] If, because of tip-splitting or tip pooling, the amount of charge tips reported by an employee on his or her Federal income tax return differs from the amount of charge tips reported by the employer for that employee on Form W–2, the rulings permit the employee to attach an explanation of the difference to his or her income tax return.

However, certain additional informational reporting is required of employers. Section 6041(a) requires every employer of an employee earning $600 or more yearly to report the total of that employee's earnings to the IRS. In interpreting this additional requirement, the regulations (sec. 1.6041–2(a)(1)) specify that any employee's earnings which are not required to be reported as subject to withholding nonetheless are required to be reported to the IRS by the employer; this additional amount is to be reported separately on the Form W–2 for the employee. Thus in the case of tip income, the IRS has ruled (Rev. Ruls. 75–400 and 76–231, *supra*) that any charge account tips actually paid over by the employer to the employee must be reported to the IRS by the employer (assuming the aggregate $600 test is met) whether or not the tips were reported to the employer by the employee.[2]

Under the cited rulings, the IRS did not apply its new employer reporting requirements with respect to charge tips unreported by employees prior to 1977. The Congress, in section 2111 of the Tax Reform Act of 1976 (P.L. 94–455), provided that the IRS is not to follow Revenue Rulings 75–400 and 76–231 until January 1, 1979, and that, in the meantime, the IRS requirements with regard to reporting charge account tips are to be made in accordance with IRS practice prior to the issuance of those rulings.

This provision of the bill does not affect the present-law authority and power of the IRS to audit individuals with respect to their income from tips.

Reasons for change

The committee has concluded that requiring employers to report to the IRS charge account tips paid to employees on the basis of charge receipts (as sought to be imposed by Revenue Rulings 75–400 and 76–231) would place unnecessary recordkeeping and reporting burdens on the employer and would fail to provide the IRS with precise information on the amount of tip income taxable to particular employees. In addition, in some cases, the widespread practices of tip-splitting and tip-pooling would result in an employer reporting to the IRS an amount of tip income that is greater than the tip income taxable to a particular employee.

Explanation of provision

The provision amends section 6041 of the Code to make the information return requirements imposed by that section inapplicable to tips with respect to which section 6053(a) of the Code applies. Accordingly, the only employee tips which an employer must report to the IRS are those reported to the employer by the employees on statements furnished pursuant to section 6053(a), as required under present law by section 6051(a).[3]

The provision also states that ,with respect to the amount of tips paid to a particular employee, the only records of charged tips which an

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[2] Under the facts of Rev. Rul. 76–231, *supra*, the employer received customer charge tickets from waiters and reviewed the tickets in order to determine the amounts payable to the employees as tips, thereby becoming aware of the amounts of such tips, whether or not later reported by the waiters to their employer.

[3] Under current sec. 6041, the IRS takes the position (in Rev. Rul. 76–231, *supra*) that employers also must report to the IRS charge account tips paid over to employees but not reported to the employer by the employees.

employer will be required to keep under section 6001 of the Code are charge receipts and copies of statements furnished by employees under section 6053(a). Accordingly, an employer will be required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but may not be required to record on such charge receipts, or otherwise keep records of (except copies of sec. 6053(a) statements), the name of any particular employee to whom the charge tip amount is paid over by the employer.

The limitation added by the bill to the recordkeeping requirements which may be imposed on an employer with respect to charged employee tips relates to records of amounts of such tips paid over to a particular employee and does not affect any other recordkeeping requirements which may be applicable to the employer under section 6001 of the Code (*e.g.*, any applicable requirements, for purposes of determining the employer's own income tax liabilities, to maintain charge receipts, records of amounts received by the employer from credit card companies, and records of aggregate payments to employees of charge account tips). Also, the bill does not affect any recordkeeping, reporting, or return requirements imposed on employers pursuant to section 6051 with respect to tips included in statements furnished by employees to the employer pursuant to section 6053(a).

There is no comparable provision in the House bill.

Effective date

This provision applies to payments made after December 31, 1978.

Revenue effect

This provision has the effect of overturning Revenue Rulings 75–400 and 76–231. If the employer reporting requirements contained in these rulings were to take effect, increases in budget receipts could be substantial. This revenue is not being collected at the present time, therefore, no change in budget receipts is estimated.

3. Postponement of effective date of carryover basis provisions (sec. 503 of the bill and sec. 1023 of the Code)

Present law

Under the Tax Reform Act of 1976, the basis of property passing from a decedent is "carried over" from the decedent to the estate or beneficiaries for purposes of determining gain or loss for sales and exchanges by the estate or beneficiaries. Under prior law, the basis of inherited property was generally stepped up or down to its value on the date of the decedent's death. The carryover basis provisions apply to property passing from decedents dying after December 31, 1976.

Reasons for change

A number of administrative problems concerning the carryover basis provisions have been brought to the attention of the committee. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Moreover, the committee believes that it should thoroughly review the basic concept of carryover basis for inherited property, as well as the administrative problems. The committee there-

fore believes that the effective date should be postponed in order to review the provisions before they become effective. However, the committee believes that the election of the carryover basis provisions should be permitted for a transitional period to cover situations where transactions have been undertaken by executors and beneficiaries in reliance upon the existing provisions.

Explanation of provisions

The bill postpones the effective date of the carryover basis provisions so that they will only apply to property acquired from decedents dying after December 31, 1979. For property passing or acquired from a decedent dying before January 1, 1980, the basis of property will be its fair market value at the date of the decedent's death or at the applicable valuation date if the alternate valuation provision is elected for estate tax purposes.

With respect to property passing or acquired from decedents dying after 1976 and before the date of enactment of the bill, the carryover basis provisions may be elected by the executor of an estate. If elected, the basis of all property considered to pass from the decedent, including jointly owned property passing by survivorship, would be determined under the carryover basis provision. The election is to be irrevocably made no later than 120 days after the date of enactment of the bill and in such manner as prescribed by the Secretary of the Treasury.

The House bill did not contain a similar provision.

Effective date

The amendments are to take effect as if included in the Tax Reform Act of 1976. Thus, the postponement applies to property passing or acquired from a decedent dying after December 31, 1976, and before January 1, 1980.

Revenue effect

It is estimated that this provision will reduce calendar years liabilities by $93 million in 1979, $162 million in 1980, $133 million in 1981, $110 million in 1982, $94 million in 1983, and by smaller amounts each year through 1999. Beyond 1999, there will be a negligible effect upon budget receipts.

Budget receipts will be reduced by $36 million in fiscal 1979, by $93 million in fiscal 1980, by $162 million in fiscal 1981, by $133 million in fiscal 1982, by $110 million in fiscal 1983, and by smaller amounts each fiscal year through 1999. Beyond 1999, there will be a negligible effect upon budget receipts.

4. Jointly-owned farms and closely held businesses (sec. 504 of the bill and sec. 2040 of the Code)

Present law

In general, Federal estate tax law provides that on the death of a joint tenant the entire value of the property owned in joint tenancy is included in a decedent's gross estate except for the portion attributable to the consideration furnished by the survivor. For this purpose, the services performed by a wife in connection with the operation of a jointly owned farm or other business would not be considered to constitute consideration furnished by the wife. Generally, dur-

ing a marriage the income derived from a jointly operated business is treated under local law as belonging to the husband if the common law rule applies within the applicable jurisdiction. The estate tax treatment of services rendered by a wife as not constituting consideration furnished for the acquisition of jointly owned property is similar in effect to the local property law treatment of joint ownership interests.

In the case of certain trade or business activities conducted jointly in the form of a family partnership, the partnership interest held by the surviving spouse will not be included in the deceased spouse's gross estate. In this situation, because of the form chosen, the effect is that the services performed by the surviving spouse in connection with the family owned business are taken into account, by reason of the profit sharing ratio, as consideration furnished for the purchase of jointly owned property used in the trade or business if a partnership is used to conduct business.

Under the Tax Reform Act of 1976, one-half of the value of a qualified joint interest is included in the gross estate of a decedent regardless of which joint tenant furnished the consideration for acquisition of the property. An interest is treated as a qualified joint interest only if the following requirements are satisfied: (1) the interest must have been created by the decedent or his spouse, or both; (2) in the case of personal property, the creation of the joint interest must be a completed gift for gift tax purposes; (3) in the case of real property, the donor must have elected to treat the creation of the joint tenancy as a taxable event for gift tax purposes; and (4) the joint tenants cannot be persons other than the decedent and his spouse.

Reason for change

The committee believes that the performance of services by a wife in connection with a jointly owned and operated farm or other business should be taken into account as consideration furnished under the estate tax law. The committee believes that recognition of the wife's services in these cases is necessary to avoid differences in treatment for cases which are substantially identical but for counseling to arrange the business operation in a proper form, such as a family partnership, so that the services performed by the wife are given some recognition.

Explanation of provision

The bill provides that the services of a wife are to be taken into account as consideration furnished for the acquisition of debt-financed jointly owned property used in a trade or business. The provision would apply only to property jointly owned by the decedent and his spouse. The services of a spouse would be taken into account only if she materially participates in the management and operation of the business. The wife would be given credit for services at the rate of 2 percent of the acquisition indebtedness for each year she materially participates and the eligible jointly owned property is used in the trade or business. The maximum allowable amount of consideration furnished under this provision would be 50 percent of the acquisition indebtedness. The actual consideration furnished by either of the joint tenants would not be subject to this provision.

The House bill does not contain a comparable provision.

Effective date

The provision applies with respect to estates of decedents dying after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $37 million in 1979, $39 million in 1980, and $46 million in 1983. Budget receipts will be reduced by less than $1 million in fiscal year 1979, $37 million in fiscal year 1980, and $43 million in fiscal year 1983.

5. Interest income on deposits in Puerto Rican branches of U.S. savings and loan associations (sec. 505 of the bill and sec. — of the Code)

Present law

U.S. citizens and resident aliens residing in Puerto Rico are, in general, subject to U.S. tax on all their income other than Puerto Rican source income (sec. 933). U.S. corporations qualifying under section 936 are entitled to a possessions credit against any U.S. tax on the foreign source income of their U.S. possessions businesses and on certain investment income from U.S. possessions sources (qualified possessions source investment income).

As a general rule, interest received from a U.S. corporation is treated as U.S. source income (sec. 861(a)(1)) and thus does not qualify for the special treatment provided for Puerto Rican source income of Puerto Rican residents (sec. 933) and possessions corporations (sec. 936) described above. However, interest paid by a domestic corporation is considered to be foreign source if less than 20 percent of the corporation's gross income is from sources within the United States (sec. 861(a)(1)(B)). If this requirement is met and more than 50 percent of the corporation's gross income is from Puerto Rican sources, then interest paid by the corporation is treated as from Puerto Rican sources in the same proportion as the corporation's gross income is from Puerto Rican sources. *Cf.* Rev. Rul. 76–535, 1976–2 C.B. 219.

As an exception to these rules, interest on deposits with a foreign branch of a U.S. commercial bank, including a branch located in Puerto Rico or another U.S. possession, is treated as income from sources within the foreign country or possession in which the branch is located (sec. 861(a)(1)(F); Treas. Reg. § 1.861–2(b)(5)). Consequently, interest paid by Puerto Rican branches of U.S. commercial banks generally qualifies for the special treatment provided Puerto Rican residents and possessions corporations.

However, this exception for foreign branches of U.S. commercial banks does not extend to foreign or possessions branches of U.S. savings and loan associations. Consequently, interest paid by those branches generally is treated as U.S. source income or, if less than 20 percent of the gross income of the savings and loan is from U.S. sources, the interest income may be treated as partially from sources within and without Puerto Rico in accordance with the source of the gross income of the savings and loan.[1] It is unclear under present law

[1] *Cf.* Rev. Rul. 76–535, 1976–2 C.B. 219.

whether or not this same source rule should be applied for purposes of the special treatment provided Puerto Rican residents and possessions corporations. As a result, unless all the income of the savings and loan association is from Puerto Rican sources, interest income received from the Puerto Rican branch of the savings and loan association (or, where applicable, a pro rata portion of the interest) may not be from Puerto Rican sources for purposes of the exclusion for residents of Puerto Rico under section 933, and also may not qualify for the possessions tax credit under section 936.

Reasons for change

The committee believes that interest on deposits with Puerto Rican branches of U.S. savings and loans should receive the same treatment for purposes of the exclusion allowed residents of Puerto Rico under section 933 and the possessions tax credit under section 936 as does interest on deposits with a Puerto Rican branch of a U.S. commercial bank.

Explanation of provision

The committee amendment expands the exception to the source rule provided in section 861(a)(1)(F) for interest on deposits in foreign branches of U.S. commercial banks to apply also to interest on deposits or withdrawable accounts with foreign branches of U.S. savings and loan associations. As the primary result of this change, it will be made clear that interest received from Puerto Rican branches of U.S. savings and loan associations will be treated as Puerto Rican source income and will thus qualify for the special treatment afforded Puerto Rican source income received by Puerto Rican residents, and the tax credit afforded to possessions corporations.

The House bill does not contain a comparable provision.

Effective date

The committee amendment applies to taxable years beginning after the date of enactment. The committee does not intend that any inference be drawn as to whether or not interest paid by Puerto Rican branches of U.S. savings and loan associations was from Puerto Rican sources for purposes of the special tax treatment provided to Puerto Rican residents and possessions corporations prior to the effective date.

Revenue effect

It is estimated that the provision will reduce budget receipts by less than $5 million a year.

6. Reduction in rate of excise tax on investment income of private foundations (see. 506 of the bill and sec. 4940 of the Code)

Present law

The Tax Reform Act of 1969 imposed a 4-percent excise tax on the net investment income of all private foundations (sec. 4940 of the Internal Revenue Code of 1954).[1] A private foundation's net invest-

[1] A private foundation that is not exempt from tax under section 501(a) is taxed on the basis of the greater of (1) the regular income tax imposed on the foundation or (2) the 4-percent excise tax on investment income plus the unrelated business income tax (imposed under sec. 511).

ment income is the sum of (1) its gross investment income and (2) the full amount of its net capital gains, this sum being reduced by the expenses paid or incurred in earning the gross investment income. Gross investment income includes interest, dividends, rents, and royalties, but does not include unrelated business income which is taxed under section 511.

Reasons for change

The 4-percent excise tax on investment income of private foundations was enacted 8 years ago. This tax has produced more than twice the revenue needed to finance the operations of the Internal Revenue Service with respect to tax-exempt organizations.

Because of the operation of the private foundations charitable distribution provisions (sec. 4942(d)), this tax reduces the minimum amount that private foundations are required to spend or grant for charitable purposes. In many cases, the tax actually has reduced charitable expenditures.

This experience with the tax and its impact on charitable expenditures has led the committee to conclude that it is now appropriate to cut the tax rate in half.

The committee also is concerned that the Internal Revenue Service devote adequate resources to the administration of those provisions of the law. The tax was instituted in the Tax Reform Act of 1969 in order to assure the availability of such resources. In section 1052 of the Employee Retirement Income Security Act of 1974, the Congress established a separate office in the Internal Revenue Service to effectively deal with this area and made a permanent authorization of appropriations to further assure the availability of sufficient resources to administer these provisions. The change in tax rate made by this bill does not reduce the amount of that permanent authorization.

The committee expects and intends that the Internal Revenue Service report annually to the tax-writing committees on the extent to which audits are conducted as to the tax liabilities of exempt organizations, the extent to which examinations are made as to the continued qualification of such organizations for their respective exempt statuses, the extent to which Service personnel are given initial and refresher instruction in the relevant portions of the law and administrative procedures, the extent to which the Service cooperates with and receives cooperation from State officials with regard to supervision of charities and other tax-exempt organizations, the costs of maintaining such programs at levels which would produce proper compliance with the laws, the amounts requested by the Executive Branch for the maintenance of those programs, and the reasons for any difference between the needed funds and the requested amounts. Also, the Internal Revenue Service is to notify the tax-writing committees of any administrative problems that the Service experiences in the course of its enforcement of the internal revenue laws with respect to exempt organizations.

Explanation of provision

The provision reduces the rate of tax imposed on the net investment income of domestic private foundations from 4 percent to 2 percent.

This provision is identical to section 1 of H.R. 112 as passed by the Senate and to H.R. 112 as passed by the House.

Effective date

The provision applies to taxable years beginning after September 30, 1977.

Revenue effect

It is estimated that this provision will reduce budget receipts by $40 million per year in fiscal years 1979–1983.

7. State tax credit against Federal slot machine excise tax (sec. 507 of the bill and secs. 4461 and 4464 of the Code)

Present law

Present law imposes an annual occupational excise tax of $250 on each slot machine or other coin-operated gaming device (sec. 4461 of the Code). If a State imposes a similar tax, the State tax is credited dollar-for-dollar against the Federal tax up to a maximum of 80 percent of the Federal tax (sec. 4464).

Reasons for change

The committee understands that the tax on slot machines was never intended as a revenue raising measure, but was instituted for oversight purposes in the area of coin-operated gaming devices. The Commission on Review of the National Policy Toward Gambling has recommended that State governments have sole jurisdiction with respect to legalized gaming activity.

The availability of the State tax credit facilitates the raising of State revenues through State taxes on slot machines. Under State law in Nevada, an amount equal to the State tax credit is used for educational purposes.

For these reasons, the committee believes that the State credit should be increased to 95 percent of the Federal tax, and that the Federal tax should be repealed for years beginning after June 30, 1980.

Explanation of provision

The provision increases the State credit against the annual Federal excise tax imposed on slot machines from 80 to 95 percent of the Federal tax amount. The increase in the State credit applies for years ending June 30, 1979, and June 30, 1980. The provision repeals the Federal excise tax for years beginning after June 30, 1980.

Effective date

The provision applies to years beginning after June 30, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $4 million in 1979, $6 million in 1980, and $7 billion in 1983. Budget receipts will be reduced by $5 million in fiscal year 1979, $6 million in fiscal year 1980, and $7 million in fiscal year 1983.

8. Study of taxation of foreign owners of U.S. real estate (sec. 508 of the bill)

Present law

Under the Code, nonresident aliens and foreign corporations, not actively engaged in the real estate business in the United States, are subject to a flat 30 percent tax on their gross current income from

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U.S. real estate investments, but they are exempt from capital gains tax on the sale of capital assets generally, and U.S. real estate in particular. They may elect, however, to be taxed on a net basis on their current income from real estate in the same manner as U.S. persons but, as a condition, must agree to be taxable on any gains from the sale of that real estate.

Foreign investors can generally avoid most or all U.S. taxes on U.S. real estate by utilizing U.S. tax treaties. If, for example, a foreign investor makes a U.S. real estate investment using a Netherlands Antilles holding company, the election to be taxed on a net basis can be made annually under the tax treaty applicable to the Netherlands Antilles. Particularly in situations where the real estate investment is financed in part with debt, it is generally possible to structure the investment so that it does not yield taxable income on a current basis. (The funds may even be lent to the holding company by the foreign investors themselves, and the interest payments would be deductible for U.S. tax purposes by the holding company but the foreign investors may be exempt from U.S. tax under the treaty on the interest they receive. *Cf.* Rev. Rul. 75–23, 1975–1 C.B. 290.) In the year the U.S. real estate is sold, the foreign investor does not make the annual election and the gain on the sale is exempt from U.S. tax under the normal Code rule for foreign investors.

Reasons for change

The committee believes it is necessary to review the application of U.S. tax laws and treaties to foreign investors in U.S. property to determine whether the present relatively favorable tax treatment afforded foreign investors should be modified.

Explanation of provision

The committee bill directs the Treasury Department to submit to Congress a study on the taxation of foreign owners of interests in U.S. property for the purpose of determining the appropriate treatment of the income or gain from these assets.

Effective date

The study is to be completed within six months of the date of enactment.

Revenue effect

The provision will have no effect on budget receipts.

9. Excessive government spending surtax (Sec. 509 of the bill and new part V of the Code)

Present law

Present law does not contain any provision relating a tax change to government spending levels.

Reasons for change

The Committee believes that a practical way to reduce the rate of growth of Federal spending is to make higher spending politically unacceptable by tying it to an automatic tax increase.

The long-run objective of this provision is to achieve a balanced budget in step-by-step fashion. The intermediate target of the provision is to reduce Federal spending from its estimated 1979 level of 21.5 percent of gross national product to 20 percent of GNP by fiscal year 1983. This goal can be accomplished by holding the rate of growth of Federal spending, adjusted for inflation, to 2 percent.

The Committee concluded that it is unrealistic to expect Federal outlays not to grow at all. Nor is it desirable. What is necessary is to limit the growth of spending. The committee concluded that permitting Federal outlays to keep pace with price increases and increase about 2 percent a year in real terms would be a reasonable goal.

Explanation of provision

The bill imposes an income tax surcharge on individuals and corporations if Federal Government spending exceeds certain limits, except in case of war or recession. The surtax is to be the rate necessary to finance the excess of Federal spending over the specified limits.

The calendar year for which the surtax would apply if Federal outlays exceed the permitted amounts and these permitted amounts (before adjustment for inflation) for fiscal years 1980 through 1983 are shown in the table below. For example, if fiscal year 1980 Federal outlays exceed $500 billion (after adjustment for inflation), the surtax would be imposed on calendar 1980 liabilities.

Calendar year of surtax and fiscal year of Federal outlays:	*Permitted amount of Federal outlays (billions)*
1980	$500
1981	510
1982	520
1983	530

For this purpose, the amount of Federal outlays for any fiscal year is defined as the amount of Federal outlays agreed to by both Houses of Congress in the second concurrent budget resolution preceding the beginning of that fiscal year except to the extent the Secretary of the Treasury determines that these amounts are incorrect because of errors of estimate or significant changes in outlays not taken into account when budget outlays were initially projected as provided for adjusting the percentage under section (b) (4).

The basic amount of Federal outlays specified for any fiscal year is to be increased by the percentage increase in the consumer price index for the 12-month period ending on June 30 immediately preceding the beginning of the fiscal year over the index for the 12-month period ending June 30, 1978.

The surtax rate is to be that percentage (rounded to the nearest whole number) determined by the Secretary of the Treasury to be necessary to finance all Federal outlays in excess of the specified limits, adjusted for inflation. For example, if in fiscal year 1981 Federal outlays (as explained above) were $600 billion, the surcharge would be

computed as follows: (1) Assuming the CPI increased at a 7-percent rate in 1979 and 1980, the specified amount of $510 billion would be increased by 14.49 percent to $584 billion. (2) The excess of $600 billion over $584 billion is $16 billion. (3) Assume, for illustration, that calendar year 1981 corporate and individiual income tax liability were to be estimated by the Secretary at $280 billion. (4) The surcharge would be obtained by dividing $16 billion by $280 billion, which yields 5.7 percent which would be rounded up to 6 percent.

In order to deal with situations where outlays are different from those agreed to in the second budget resolution the secretary is given the authority to adjust the percentage whenever necessary, but not more than twice during any 12-month period, to compensate for errors of estimate or significant changes in Federal outlays or revenues not taken into account when the percentage was determined or previously adjusted.

The surtax is to apply to tax before credits rather than after credits. The surtax does not apply to certain taxes, including the minimum tax.

The surtax is to be suspended for any calendar year in which the unemployment rate (as determined by the Bureau of Labor Statistics) exceeds 7 percent for 3 months in a row or for any period during which a declaration of war is in effect.

The Secretary of the Treasury is directed to note on the Federal tax forms that this surtax is a result of growth in Federal spending in excess of 2 percent per year.

Effective date

This provision is to be effective upon enactment, but the surtax could not apply until calendar year 1980.

Revenue effect

This provision is not expected to yield any revenue because it is assumed that it would be a sufficiently effective deterrent to Federal spending increases that Congress would not trigger the tax.

O. Provisions Related to Social Security Act Programs

1. Fiscal relief for State and local welfare costs

(SECTION 601 OF THE BILL)

Present law

Increased welfare costs have imposed a difficult fiscal burden on States and localities in recent years. This has been particularly true in those areas that have tried to maintain adequate levels of benefits through their various social welfare programs, including aid to families with dependent children, supplemental security income, medicaid, social services and general assistance. Nationwide, there has been nearly a 50 percent increase in State and local expenditures for these programs in the last 5 years.

State and local expenditures for the AFDC program alone have increased from $3.4 billion in 1973 to an estimated $5.5 billion in 1978. In 1967, States and localities bore 42 percent of the cost of the AFDC program. Currently they are bearing 46 percent of the cost.

Each State's share of AFDC cash maintenance payments is determined by a formula which provides Federal matching of State payments at a rate of 50 to 83 percent, depending upon the State's per capita income. The following table shows the distribution of expenditures for AFDC payments for each State for 1976. Preliminary expenditure data provided by the Department of Health, Education, and Welfare indicate that, although overall expenditures for AFDC will show an increase for 1977, the proportions borne by States and localities will not be substantially different from 1976.

TABLE P-1.—AID TO FAMILIES WITH DEPENDENT CHILDREN (AFDC), TOTAL MAINTENANCE ASSISTANCE PAYMENTS, FISCAL YEAR 1976

State	Total payments computable for Federal funding	Federal funds (unadjusted)	Local funds	State funds	Percentage		
					Federal funds	Local funds	State funds
Alabama	$61,864,423	$46,923,718		$14,940,705	75.8	0	24.2
Alaska	13,457,182	6,623,664		6,833,518	49.2	0	50.8
Arizona	33,977,273	18,895,181		15,082,092	55.6	0	44.4
Arkansas	50,159,256	37,418,805		12,740,451	74.6	0	25.4
California	1,424,692,553	712,346,276	$253,580,487	458,765,790	50.0	17.8	32.2
Colorado	83,227,441	45,517,087	16,700,968	21,009,386	54.7	20.1	25.2
Connecticut	131,786,271	65,893,135		65,893,136	50.0	0	50.0
Delaware	23,649,023	11,824,511		11,824,512	50.0	0	50.0
District of Columbia	91,865,652	45,932,825		45,932,827	50.0	0	50.0
Florida	120,436,323	68,315,478		52,120,845	56.7	0	43.3
Georgia	122,679,985	90,120,035		32,559,950	73.5	0	26.5
Guam [1]	1,511,650	755,825		755,825	50.0	0	50.0
Hawaii	64,632,077	32,316,039		32,316,038	50.0	0	50.0
Idaho	19,796,706	13,497,394		6,299,312	68.2	0	31.8
Illinois	720,065,139	358,715,572		361,349,567	49.8	0	50.2
Indiana	115,583,003	66,425,552	20,351,153	28,806,298	57.5	17.6	24.9
Iowa	98,783,931	56,435,260		42,348,671	57.1	0	42.9
Kansas	67,602,756	36,519,009		31,083,747	54.0	0	46.0
Kentucky	132,730,945	94,730,076		38,000,869	71.4	0	28.6
Louisiana	98,429,037	71,272,467		27,156,570	72.4	0	27.6
Maine	46,662,236	32,943,539		13,718,697	70.6	0	29.4
Maryland	154,441,383	77,220,692	4,413,052	72,807,639	50.0	2.9	47.1
Massachusetts	415,121,135	207,560,568		207,560,567	50.0	0	50.0
Michigan	746,719,100	373,359,550		373,359,550	50.0	0	50.0
Minnesota	156,149,764	88,757,624	29,087,774	38,304,366	56.9	18.6	24.5
Mississippi	32,017,662	26,504,646		5,513,016	82.8	0	17.2
Missouri	140,017,934	85,774,453		54,243,481	61.3	0	38.7

Montana	12,786,884	8,082,589	1,008,552	3,695,743	63.2	7.9	28.9
Nebraska	28,780,341	15,998,096	.....	12,782,245	55.6	0	44.4
Nevada	10,317,578	5,158,789	.....	5,158,789	50.0	0	50.0
New Hampshire	23,673,490	14,270,380	6,700	9,396,410	60.2	.....	39.7
New Jersey	426,793,857	213,396,928	52,226,857	161,170,072	50.0	12.2	37.8
New Mexico	32,125,612	23,544,860	.....	8,580,752	73.3	0	26.7
New York	1,563,184,768	766,768,978	428,746,351	367,669,439	49.1	27.4	23.5
North Carolina	123,889,145	84,281,786	19,711,194	19,896,165	68.0	16.0	16.0
North Dakota	13,122,019	7,556,970	1,044,992	4,520,057	57.6	8.0	34.4
Ohio	446,319,654	242,753,261	.....	203,566,393	54.4	0	45.6
Oklahoma	65,506,367	44,164,394	.....	21,341,973	67.4	0	32.6
Oregon	113,521,471	67,023,078	1,165	46,497,228	59.0	.....	41.0
Pennsylvania	650,945,260	360,558,579	.....	290,386,681	55.4	0	44.6
Puerto Rico	24,171,922	12,085,960	.....	12,085,962	50.0	0	50.0
Rhode Island	51,270,478	28,993,455	.....	22,277,023	56.5	0	43.5
South Carolina	46,352,487	35,670,249	.....	10,682,238	77.0	0	23.0
South Dakota	20,140,672	13,540,573	.....	6,600,099	67.2	0	32.8
Tennessee	85,756,646	62,722,396	.....	23,034,250	73.1	0	26.9
Texas	137,686,030	100,157,072	.....	37,528,958	72.7	0	27.3
Utah	35,237,274	24,680,187	.....	10,557,087	70.0	0	30.0
Vermont	26,538,100	18,528,902	.....	8,009,198	70.0	0	30.0
Virgin Islands	1,849,649	924,824	.....	924,825	50.0	0	50.0
Virginia	138,678,345	80,904,947	1,462,344	56,311,054	58.3	1.1	40.6
Washington	160,546,774	86,245,728	.....	74,301,046	53.7	0	46.3
West Virginia	52,466,290	37,671,723	.....	14,794,567	71.8	0	28.2
Wisconsin	210,875,774	126,335,680	.....	84,540,094	59.9	0	40.1
Wyoming	4,900,181	2,986,169	684,505	1,229,507	60.9	14.0	25.1
Total	9,675,496,908	5,257,605,534	829,026,094	3,588,865,280	54.3	8.6	37.1

[1] The sum of $755,825 was reported by Guam as a *local* expenditure; but is reported here as a *State* (territorial) expenditure. Adjustments have been made for errors in the printed report.

Source: Office of Financial Management. Division of Finance. Fiscal year 1976 State expenditures for public assistance programs approved under titles I, IV-A, X, IV, XVI, XIX, XX of the Social Security Act. (SRS) 77-04023. This report is compiled from State expenditure reports submitted quarterly by States.

The need to provide some relief for welfare costs now being borne at the State and local levels was recognized earlier by the 95th Congress when it approved $187 million in fiscal relief payments to States under the AFDC program for fiscal year 1978. This amount, which was agreed to by a House-Senate Conference as part of the Social Security Amendments of 1977 (P.L. 95–216) was half of the amount approved earlier by the Senate in its version of the 1977 Social Security Act amendments. The conferees agreed that the second half of the 1978 Senate fiscal relief amount would be considered as part of H.R. 7200, the Public Assistance Amendments of 1977. However, that bill has not yet been considered by the full Senate.

H.R. 7200, as reported by the Finance Committee, also included provision for up to $500 million in fiscal relief for States and localities for fiscal year 1979.

Committee provision

The committee believes that, although it may not be possible to act on all the provisions of H.R. 7200 this year because of insufficient time to consider its many important provisions, the issue of fiscal relief is an urgent one which should not be delayed until the next Congress. Thus the committee bill includes a provision for welfare fiscal relief for 1979 which is essentially the same as the provision which it approved last year as part of H.R. 7200.

The committee bill would make available an estimated $400 million in additional Federal funding for AFDC costs for 1979. This one-time provision would be payable as soon as possible after March 31, 1979. The payment would be based on an allocation of $500 million on the basis of a two-part formula. Half of the fiscal relief funds would be allocated to each State in proportion to its share of total expenditures under the program of aid to families with dependent children for December, 1976, and half would be allocated under the general revenue sharing formula.

To receive its full share of the payment, however, each State would have to demonstrate that it had reduced its payment error rate in the AFDC program to 4 percent or less as of the October, 1978-March, 1979 quality control sampling period. For purposes of this provision, the payment error rate would be calculated by considering excess payments made to recipients, that is, payments to ineligible individuals and overpayments to eligible persons. States which had not reached a 4-percent-or-less payment error rate by that period could still receive some payment depending on the degree of their progress toward that rate since a base period. At State option, the base period could be either the July–December, 1974 or January–June, 1975 quality control sampling period. If, for example, a State had a 10-percent error rate in the base period and had reduced that error rate to 8 percent as of October, 1978—March, 1979, the State would receive a payment equal to one-half of its full fiscal relief allocation since it had progressed one-half of the way toward the 4-percent goal. In any case, a State would receive at least 90 percent of its full allocation if its AFDC error rate for October, 1978—March, 1979 is 5 percent or less. A State would receive at least 75 percent of its full allocation if its error rate in that period is 6 percent or less.

The committee has long been concerned about weaknesses in administration of the AFDC program and about the very high error rates that have characterized AFDC payments in recent years. The committee recognizes that both the Administration and the States have been placing increasing emphasis on the need to improve the eligibility determination process, and that significant progress has been made in reducing errors under the AFDC program. The provision for relating State fiscal relief payments to improvements in quality control error rates is included as a way of rewarding those States that have already successfully reduced their error rates to low levels, and as an incentive to other States to make needed improvements. The provision emphasizes the committee's belief that improved AFDC administration should be a major concern of the Department of HEW, in order to assure that those persons who are most in need of help are indeed the persons who receive it.

In most States the cost of the non-Federal share of AFDC is borne entirely by the State. However, a number of States require substantial contribution by localities to the cost of the program. States reporting local contributions ranging from 1 to 27 percent of the cost of AFDC maintenance payments in fiscal year 1976 include: California, Colorado, Indiana, Maryland, Minnesota, Montana, New Jersey, New York, North Carolina, North Dakota, Virginia, and Wyoming. Localities in these States can expect to benefit from the provision in the committee bill which requires the States to pass the fiscal relief through to localities in any case where local governments pay part of the program's costs. However, States would not be required to pass through an amount in excess of 90 percent of the AFDC costs for which the local government was otherwise responsible. (It is intended that this amount paid to localities would be allocated among the various local jurisdictions in the State in proportion to each locality's share of AFDC costs.)

Although the fiscal relief provisions of the committee bill would be computed under a formula related in part to the AFDC program and would be provided to the States in the form of increased funding for that program, the committee wishes to make clear that it views these provisions as an attempt to provide some relief for the overall welfare burden faced by the States. That burden falls not only on the AFDC program but also in the areas of aid to the aged, blind, and disabled in States which supplement the SSI program, in medicaid and general assistance, and in programs of social and child welfare services.

Table P–2 shows how the fiscal relief payment under the bill would be distributed among the States.

TABLE P–2.—FISCAL RELIEF FOR WELFARE COSTS UNDER COMMITTEE BILL

[Dollars in thousands]

State	Percentage distribution	Unreduced allocation	Error rate in cash payments (percent)			Percent progress toward 4-percent error rate	Share of 1977 already achieved
			July–December 1974	January–June 1975	July–December 1977		
Total	100.0	500,000					310,401
Alabama	1.1	$5,719	11.2	8.6	5.8	75.0	$4,289
Alaska	.2	1,184	11.2	9.4	12.8		
Arizona	.7	3,711	17.5	18.0	8.4	68.6	2,544
Arkansas	.7	3,660	5.3	6.7	9.3		
California	13.6	68,104	9.2	8.4	3.9	100.0	68,104
Colorado	.9	4,740	10.5	10.0	4.8	90.0	4,266
Connecticut	1.3	6,648	8.7	9.1	6.9	43.1	2,868
Delaware	.3	1,394	16.1	18.3	7.0	79.0	1,102
District of Columbia	.6	3,191	17.0	18.6	20.1		
Florida	2.1	10,655	16.2	12.7	6.1	82.8	8,821
Georgia	1.6	8,066	18.4	18.3	10.1	57.6	4,649
Hawaii	.6	3,025	11.4	13.4	10.1	35.1	1,062
Idaho	.3	1,428	4.9	6.0	2.7	100.0	1,428
Illinois	6.2	30,847	23.8	19.0	17.6	31.3	9,659
Indiana	1.6	7,814	6.7	4.5	2.0	100.0	7,814

Iowa	1.1	5,303	11.9	12.0	7.1	61.3	3,248
Kansas	.8	4,036	15.5	13.8	7.9	66.1	2,667
Kentucky	1.5	7,443	9.3	11.1	8.5	36.6	2,726
Louisiana	1.5	7,695	12.2	7.4	8.4	46.3	3,566
Maine	.6	2,825	11.7	16.4	9.0	59.7	1,686
Maryland	1.8	8,756	20.1	17.7	13.8	39.1	3,426
Massachusetts	3.8	18,966	17.9	19.8	11.7	51.3	9,723
Michigan	5.7	28,335	14.7	13.7	10.1	43.0	12,181
Minnesota	1.7	8,633	11.8	7.9	4.9	90.0	7,770
Mississippi	.9	4,428	5.3	5.3	9.3	.....	.....
Missouri	1.7	8,315	13.7	11.2	14.1	.....	.....
Montana	.3	1,273	14.4	21.7	8.8	72.9	928
Nebraska	.4	2,234	16.6	8.7	4.0	100.0	2,234
Nevada	.2	826	.4	.5	0	100.0	826
New Hampshire	.3	1,321	24.1	15.3	5.8	91.0	1,202
New Jersey	3.8	18,967	8.2	6.7	3.7	100.0	18,967
New Mexico	.5	2,273	6.3	6.0	4.9	90.0	1,384
New York	14.1	70,533	21.7	15.4	11.9	55.4	39,052
North Carolina	1.9	9,458	11.9	7.9	6.4	69.6	6,585
North Dakota	.2	990	2.0	.8	1.9	100.0	990
Ohio	4.2	20,987	15.9	17.7	10.8	50.4	10,570
Oklahoma	.9	4,339	3.5	3.5	4.6	90.0	3,905
Oregon	1.2	5,978	8.3	8.1	6.1	51.2	3,058
Pennsylvania	5.9	29,544	13.6	13.3	9.7	40.6	12,002
Rhode Island	.5	2,390	9.8	7.9	4.3	94.8	2,266

TABLE P–2.—FISCAL RELIEF FOR WELFARE COSTS UNDER COMMITTEE BILL—Continued

[Dollars in thousands]

State	Percentage distribution	Unreduced allocation	Error rate in cash payments (percent)			Percent progress toward 4-percent error rate	Share of 1977 already achieved
			July–December 1974	January–June 1975	July–December 1977		
South Carolina	0.9	$4,510	12.5	9.9	6.7	68.2	$3,078
South Dakota	.3	1,305	5.7	9.9	1.7	100.0	1,305
Tennessee	1.4	6,775	12.7	2.5	7.7	57.5	3,894
Texas	3.0	15,230	7.7	5.1	5.2	75.0	11,423
Utah	.5	2,408	8.4	10.6	3.8	100.0	2,408
Vermont	.3	1,268	7.9	9.2	6.3	55.8	707
Virginia	1.7	8,561	9.0	7.5	8.6	8.0	685
Washington	1.4	7,056	6.4	5.5	4.9	90.0	6,350
West Virginia	.7	3,349	5.5	4.5	4.9	90.0	3,014
Wisconsin	2.3	11,487	7.7	9.0	5.2	76.0	8,730
Wyoming	.1	601	11.9	9.0	7.6	54.4	327
American Samoa							
Guam	(*)	126					
Puerto Rico	.2	1,202	16.2	12.6	7.3	71.3	857
Virgin Islands	(*)	87	12.8	21.1	10.3	63.2	55

*Less than 0.05 percent. Based on information supplied by the Department of Health, Education, and Welfare (AFDC data) and the Treasury Department (revenue sharing data).

2. Increase in Title XX Social Services ceiling

(SECTION 602 OF THE BILL)

Present law

In addition to providing Federal funding for cash public assistance to certain categories of needy individuals, the welfare titles of the Social Security Act have provided funding for a variety of social services programs. Originally, the costs of social services were considered a part of the administrative costs of operating cash public assistance programs, but subsequent amendments provided separate recognition of social services programs, expanded their availability to persons not receiving cash assistance, permitted funding of services provided by other than the welfare agency itself (including services by non-public agencies), and increased the Federal rate of matching to 75 percent (90 percent in the case of family planning services).

Prior to fiscal year 1973, Federal matching for social services, like Federal matching for welfare payments, was mandatory and open-ended. Every dollar a State spent for social services was matched by three Federal dollars. In 1971 and 1972 particularly, States made use of these provisions to increase at a rapid rate the amount of Federal money going into social services programs.

In 1972, the Congress established a $2.5 billion annual ceiling on the amount of Federal funding for social services programs effective for fiscal year 1973 and subsequent fiscal years. Under this overall national ceiling, each State has a ceiling established which is based on its population relative to the population of the entire Nation.

In 1974, Congress substantially revised the statutes governing the social services programs. The 1974 legislation transferred the provisions governing social services programs from the cash public assistance titles of the Social Security Act to a new separate services title (title XX). The Federal matching percentage for services remained at 75 percent under the new title XX program and the overall ceiling of $2.5 billion allocated among the States on a population basis was not changed.

The amount of the general title XX spending ceiling has not been increased since 1972. The only additional funding which has been available to the States for social services has been earmarked for child care services. The 94th and 95th Congresses authorized $200 million for child care for each of fiscal years 1977 and 1978.

Since the enactment of the Social Services Amendments in 1974, many States have undertaken to revise and strengthen their social services programs. Efforts have been made to expand the variety of services offered and to expand eligibility to a broader segment of the population. The result has been that although only 17 States were spending all or nearly all of their full allocation under title XX in 1975, 41 States are at or near their spending ceiling at the present time. The following table shows the number of States using less than their full allocation under title XX.

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TABLE P-3.—NUMBER OF STATES USING LESS THAN FULL AVAILABLE TITLE XX FUNDING UNDER $2.5 BILLION CEILING, 1975–79

[Number of States]

Fiscal year	98 to 100 percent of ceiling	90 to 98 percent of ceiling	80 to 90 percent of ceiling	Less than 80 percent of ceiling	Federal cost (000)
1975	12	5	5	29	$1,962,581
1976	18	7	9	17	2,130,380
1977 [1]	19	14	9	9	2,259,726
1978 [1]	35	6	6	4	2,382,604
1979 [1]	48	1	1	1	2,450,000

[1] Estimated.

Source: Fiscal 1979 budget estimates, Department of Health, Education, and Welfare.

The law allows each State to decide the kinds of services it wishes to provide. It is estimated that child care services will consume about 22 percent of Federal title XX funds in 1979. Other major services provided are homemaker/chore services and services involving education, training and employment. Although States vary widely in the way they spend their social services funds, the following table shows how funds are expected to be spent in 1979 for the Nation as a whole.

TABLE P-4.—TITLE XX SERVICES: ESTIMATED DISTRIBUTION OF FEDERAL FUNDING BY TYPE OF SERVICES AND NUMBER OF RECIPIENTS, FISCAL 1979

[In thousands]

Type of service	Number of recipients	Federal funding	
		Amount	Percent
Total	([1])	$2,650,000	100.0
Child day care	649	580,350	21.9
Homemaker/chore	411	302,100	11.4
Education, training and employment	511	272,950	10.3
Protective services	723	262,350	9.9
Child foster care	327	222,600	8.4
Counseling	642	185,500	7.0
Health-related services	804	127,200	4.8
Residential care	123	95,400	3.6
Family planning	312	63,600	2.4
Other	([2])	537,950	20.3

[1] Number of recipients is not additive as recipients may receive more than 1 type of service.
[2] Not estimated.

Source: Fiscal 1979 budget estimates, Department of Health, Education, and Welfare.

Committee provision

The committee believes that in order to assure that States can continue to offer their current level of services in this period of high inflation, the overall ceiling on spending for title XX should be adjusted to take into account the increase in the cost of living that has taken place in the last year. Based on the $2.7 billion amount available to the States for fiscal year 1978, this adjustment requires an increase of approximately $200 million. The committee bill therefore provides an overall ceiling for 1979 of $2.9 billion. As under the temporary provisions of Public Law 94–401, however, $200 million will be earmarked for child care services and will be allocated to the States on the basis of State population, using the regular title XX distribution formula. These funds will be available to the States for child care on a 100 percent Federal funding basis. The current Federal matching rate of 75 percent (90 percent for family planning) will continue for the other $2.7 billion of title XX funds.

The following table shows how the funds made available under the committee's bill would be allocated.

TABLE P–5.—ALLOCATION OF 1979 TITLE XX FUNDS UNDER THE COMMITTEE BILL

State	Allocation of $2.9 billion	Amount of allocation earmarked for child care
Alabama	49,524,000	3,415,000
Alaska	5,162,000	356,000
Arizona	30,674,000	2,115,000
Arkansas	28,498,000	1,965,000
California	290,790,000	20,054,000
Colorado	34,903,000	2,407,000
Connecticut	42,119,000	2,905,000
Delaware	7,864,000	542,000
District of Columbia	9,486,000	654,000
Florida	113,789,000	7,848,000
Georgia	67,158,000	4,632,000
Hawaii	11,986,000	827,000
Idaho	11,229,000	774,000
Illinois	151,733,000	10,464,000
Indiana	71,644,000	4,941,000
Iowa	38,781,000	2,675,000
Kansas	31,214,000	2,153,000
Kentucky	46,321,000	3,195,000
Louisiana	51,902,000	3,579,000
Maine	14,458,000	997,000

TABLE P-5.—ALLOCATION OF 1979 TITLE XX FUNDS UNDER THE COMMITTEE BILL—Continued

State	Allocation of $2.9 billion	Amount of allocation earmarked for child care
Maryland	55,996,000	3,862,000
Massachusetts	78,494,000	5,413,000
Michigan	123,018,000	8,484,000
Minnesota	53,577,000	3,695,000
Mississippi	31,809,000	2,194,000
Missouri	64,563,000	4,453,000
Montana	10,175,000	702,000
Nebraska	20,985,000	1,447,000
Nevada	8,243,000	569,000
New Hampshire	11,107,000	766,000
New Jersey	99,128,000	6,836,000
New Mexico	15,783,000	1,089,000
New York	244,361,000	16,852,000
North Carolina	73,900,000	5,097,000
North Dakota	8,689,000	599,000
Ohio	143,869,000	9,922,000
Oklahoma	37,376,000	2,578,000
Oregon	31,471,000	2,170,000
Pennsylvania	160,286,000	11,054,000
Rhode Island	12,526,000	864,000
South Carolina	38,484,000	2,654,000
South Dakota	9,270,000	639,000
Tennessee	56,942,000	3,927,000
Texas	168,731,000	11,637,000
Utah	16,593,000	1,144,000
Vermont	6,432,000	444,000
Virginia	67,995,000	4,689,000
Washington	48,807,000	3,366,000
West Virginia	24,606,000	1,697,000
Wisconsin	62,279,000	4,295,000
Wyoming	5,270,000	364,000

Source: Department of Health, Education, and Welfare.

The committee bill would also provide States with additional flexibility in planning their social services programs. Present law requires that States develop annual plans describing how funds are to be used and who will be eligible for services. The planning process required in law provides for publication by the State of a proposed plan and for a

period during which public comment must be accepted. Federal regulations place additional requirements on the States for consultation with various parties involved in social services programs either as providers or as consumers.

After several years experience with the annual planning process, a number of States have concluded that their planning could best be done on a multi-year basis. In its proposed social services amendments this year the Administration recommended that States be allowed to develop plans for up to 3 years. The committee agrees that it is desirable to allow States to develop plans over a longer period of time, according to their needs, and therefore has provided that States may use a 1, 2, or 3-year planning process. As under present law, State plans could be amended at any time.

In addition, the committee has been informed that some States are hindered in coordinating their social services programs by the requirement in present law that they use either the Federal or State fiscal year for their title XX services' program year. The committee bill would give these States added flexibility by allowing them also the choice of using the county fiscal year. Within any one State, however, the planning period would have to be a single period of either 12, 24, or 36 months.

3. Management Information System

(SECTION 603 OF THE BILL)

Present law

There is increasing evidence that administration of the AFDC program could be significantly improved if States establish and use computerized information systems in the management of their programs. Such systems have been demonstrated to be helpful in program planning and evaluation. They also make day-to-day operations more efficient, and they are crucial to assuring that eligibility determinations are properly made and that fraud and abuse are discovered on a timely and ongoing basis. Although the merits of such systems are generally recognized, the States have been slow to develop them because of the large initial outlays which are necessary, and because of the ongoing cost of operating them. States may currently receive Federal matching for the systems as an administrative cost, but Federal matching is limited to 50 percent. This is in contrast to the medicaid program, in which 90 percent Federal matching is authorized for the cost of developing and implementing computer systems, and 75 percent for their operation.

Committee provision

The committee is convinced that the administration of State AFDC programs could be greatly improved through judicious use of modern computerized management information systems. Recipients could be expected to benefit from more expeditious handling of their cases and decreases in processing time; local, State, and Federal Governments—and the taxpayer—could be expected to benefit from a decrease in costs because of a reduction in errors and use of better planning and management techniques.

Thus, the committee amendment would provide an incentive to the States to develop and expand their existing systems by increasing the rate of matching to 90 percent for the costs of developing and implementing the systems and to 75 percent for the costs of operating them, provided the system meets the requirements imposed by the amendment.

Under the committee amendment, the Department of Health, Education, and Welfare would be required, on a continuing basis, to provide technical assistance to the States and would have to approve the State system as a condition of Federal matching. (Continuing review of the State systems would also be required.) To qualify for HEW approval, the system would have to have at least the following characteristics: (1) Ability to provide data concerning all AFDC eligibility factors; (2) capacity for verification of factors with other agencies through identifiable correlation factors such as social security numbers, names, dates of birth, home addresses and mailing addresses (including postal ZIP codes); (3) ability to control and account for the costs, quality and delivery of funds and services furnished to applicants and recipients; (4) capability for notifying child support, food stamp, social service, and medicaid programs of changes in AFDC eligibility or benefit amount; and (5) security against unauthorized access to or use of the data in the system.

In approving systems, the Department would have to assure sufficient compatibility among the other public assistance, medicaid, and social services systems in the States and among the AFDC systems of different jurisdictions to permit periodic screening to determine whether an individual was drawing benefits from more than one jurisdiction and for determination of eligibility and payment pursuant to requirements imposed by other sections of the Social Security Act. (The increased matching would be applicable to existing systems if they meet the criteria for approval of new systems.)

Such approval would be based on the Secretary's finding that the initial and annually updated advanced automatic data processing document, which each State must have, will, when implemented, generally carry out the objectives of the statewide management system. Such a document would provide for the conduct of and reflect the results of requirements analysis studies, contain a description of the proposed statewide management system, indicate the security and interface requirements in the system, describe the projected and expected to be available resource requirements for staff and other needs, include cost-benefit analyses of each alternative management system, data processing services and equipment and a plan showing the basis for both indirect and direct rates to be in effect, contain an implementation plan to handle possible failure of contingencies, and contain a summary of the system in terms of qualitative and quantitative benefits.

4. Work Incentive Program

(SECTION 604 OF THE BILL)

Present law

Adult members of the AFDC families who are capable of employment are required to register for participation in the work incentive (WIN) program established under title IV–C and to accept training

or employment offered through that program. Federal funding for the WIN program, including the costs of necessary supportive services, is provided at a 90-percent matching rate. This program is subject to annual appropriations and is presently funded at a level of $365 million. Legislation enacted earlier this year (Public Law 95–30) authorized additional appropriations up to $435 million for fiscal years 1978 and 1979 to be used without any non-Federal matching requirement. No funding under that provision has yet been appropriated.

The work incentive program was originally enacted by Congress in 1967 with the purpose of reducing welfare dependency through the provision of manpower training and job placement services. In 1971 the Congress adopted amendments aimed at strengthening the administrative framework of the program and at placing greater emphasis on immediate employment instead of institutional training, thus specifically directing the program to assist individuals in the transition from welfare to work. In the same year, Congress also provided for a tax credit to employers who hire WIN participants, equal to 20 percent of the wages paid for a maximum of 12 months' employment.

The 1971 amendments required that all persons at least 16 years of age and receiving AFDC benefits must register for WIN, unless caretaker of a child under age, legally exempt by reason of health, disability, needed in the home, advanced age, student status, or geographic location. Registrants selected for participation in WIN must accept available jobs, training, or needed services to prepare them for employment. Refusal to do so without good cause will result in termination of their AFDC payments.

Since these amendments were enacted, there has been a significant increase in the number of persons placed in employment with resultant savings in AFDC funding. In fiscal year 1976 and the following transition quarter, 237,000 WIN registrants entered employment. Of these, 105,000 individuals, plus the children of these individuals, went off of welfare completely. In fiscal year 1977, 271,000 WIN registrants entered employment with 136,200 of these individuals and their families going off welfare. Statistics for the first 6 months of fiscal year 1978 indicate that this success is continuing. In that brief period, 133,000 AFDC recipients entered employment, and 82,700 of them. with their families, left welfare as a result of sufficiently high earnings,

Committee provision

Despite the growing success of the WIN program, the committee believes that the program should be strengthened in such a way as to provide additional encouragement for welfare recipients to move into employment. The committee further believes that AFDC recipients who are able to work should be required to actively seek employment and that this should be made explicit in the law. The committee amendment therefore would amend title IV–A to provide that AFDC recipients who are not excluded from WIN registration by law will be required, as a condition of continuing eligibility for AFDC, to participate in the full range of employment-related activities which are part of the WIN program, including employment search activities. The committee anticipates that with such an employment search requirement, substantial numbers of AFDC recipients will find jobs and welfare costs will be reduced.

The employment search mandated by the committee amendment is not to be mechanically applied to require every individual to make a specific number of employment contacts. Rather, the term is to be interpreted to mean those activities determined by the State agency to be appropriate for WIN registrants to undertake to actively seek employment. The specifics of what constitutes employment search may be varied within different labor market areas within a State to reflect present labor market conditions, probable job openings, and the basic employability characteristics of the WIN registrants. Employment search activites are intended to be directed by professional manpower staff and supported by necessary services. Thus the amendment would require the provision of such social and supportive services as are necessary to enable the individual actively to engage in activities related to finding employment and, for a period thereafter, as are necessary and reasonable to enable him to retain employment. For example, transportation costs which are necessary for employment search would be covered, as would the costs of necessary child care. However, the committee expects the program to be so managed that the need for child care will be minimized.

Under present law State matching for social and supportive services must be in the form of cash. The committee amendment would make it easier for the State to provide the required 10 percent State matching by allowing matching in the form of in-kind goods and services.

The amendment would provide for locating manpower and supportive services together to the maximum extent feasible, eliminate the requirement for a 60-day counseling period before assistance can be terminated, and authorize the Secretaries of Labor and HEW to establish the period of time during which an individual will not be eligible for assistance in the case of a refusal without good cause to participate in a WIN program. The amendment also clarifies the treatment of earned income derived from public service employment, and adds to those excluded from the WIN registration requirement, individuals who are working at least 30 hours a week.

5. Incentive To Report Income

(SECTION 605 OF THE BILL)

Present law

Quality Control reviews show that a large percentage of the payment errors made in the AFDC program relate to earned income and the failure of the recipient to report the correct amount of any changes in amount earned. Of all cases involving error, the major concentration was in earned income—over 22 percent. A few States require that all income be reported on a monthly basis, as a condition of eligibility. Most States do not do this. When they learn that a recipient had unreported earned income in prior months, they give him the benefit of all the earned income disregards provided in law in calculating the amount of the overpayment. Thus, if a recipient is negligent in reporting his earnings even over a long period of time there is no penalty involved.

Committee provision

The committee believes that there should be an incentive in the law for recipients with earnings to report their income on a prompt and complete basis. The committee amendment would accomplish this by providing that there would be no disregard of any earned income which the recipient has not reported to the State agency. This provision should have a significant impact in reducing errors and problems of overpayments.

6. Matching for Child Support Costs of Court Personnel

(SECTION 606 OF THE BILL)

Present law

The child support enforcement program, enacted at the end of the 94th Congress as title IV–D of the Social Security Act (Public Law 93–647), mandates aggressive administration at both the Federal and local levels with various incentives for compliance and with penalties for noncompliance. The program includes child support enforcement services for both welfare and nonwelfare families. The child support enforcement program leaves basic responsibility for child support and establishment of paternity to the States, but provides for an active role on the part of the Federal Government in monitoring and evaluating State child support enforcement programs, in providing technical assistance, and, in certain instances, in undertaking to give direct assistance to the States in locating absent parents and obtaining support payments from them.

To assist and oversee the operation of State child support programs, the Department of Health, Education, and Welfare is required to set up a separate organizational unit under the direct control of a person designated by and reporting to the Secretary. This office reviews and approves State child support enforcement plans, evaluates and audits the implementation of the program in each State, and provides technical assistance to the States.

HEW regional child support staff, under the regional child support representative, are responsible solely for title IV–D and report directly to the Office of Child Support Enforcement. The manner in which the Department of Health, Education, and Welfare has complied with the requirement of a separate organizational unit for child support enforcement is in keeping with the spirit and intent of present law and is analogous to the organizational structure for child support enforcement in many States—particularly States with highly cost-effective programs such as Michigan, Massachusetts, Washington and Iowa.

The Act also provides for a parent locator service within the Department of HEW's separate child support enforcement unit. The Act further requires that a mother, as a condition for welfare, assign her right to support payments to the State and cooperate in identifying and locating the father and securing support payments except when cooperation is determined not to be in the best interest of the child.

The legislation requires that State child support plans provide for entering into cooperative arrangements with appropriate courts and law enforcement officials to assist the child support agency in adminis-

tering the program. The law specifically requires the entering into of financial arrangements with such courts and officials in order to assure optimum results under the child support program and with respect to any other matters of common concern to the courts and the child support agency. Federal regulations are now written in such a way as to allow States to claim Federal matching for the compensation of district attorneys, attorneys general and similar public attorneys and prosecutors and their staff. However, States may not receive Federal matching for compensation of judges.

In the first 35 months of the child support program (August 1975 through June 30, 1978), States have reported total collections of over $2.5 billion of which $1.2 billion was for AFDC families and $1.3 billion was for families not on welfare, at a total cost of $0.7 billion or 28 cents per dollar collected. The following table shows the total collections and expenditures by States for the first 35 months.

The increasing success of the child support employment program is reflected not just by the amounts of child support collected, but also by other program results.

TABLE P-6.—CHILD SUPPORT COLLECTIONS AND EXPENDITURES (AUG. 1, 1975–JUNE 30, 1978)

	Total AFDC collections	Total non-AFDC collections	Total collections	Total expenditures
Totals	[1] $1,169,114,961	$1,291,447,932	[1] $2,460,562,893	$700,533,756
Alabama	4,839,610	40,952	4,880,562	6,900,027
Alaska	550,919	7,862,188	8,413,107	2,064,022
Arizona	918,281	645,591	1,563,872	3,383,494
Arkansas	2,156,158	359,745	2,515,903	2,695,633
California	179,380,763	203,600,616	382,981,379	176,710,023
Colorado	8,175,150	2,269,337	10,444,487	7,064,006
Connecticut	23,612,242	30,034,249	53,646,491	9,164,319
Delaware	3,200,246	13,501,342	16,701,588	1,887,288
District of Columbia	1,605,072	69,085	1,674,157	2,450,498
Florida	8,579,227	1,123,156	9,702,383	9,084,327
Georgia	9,841,364	1,192,877	11,034,241	3,824,577
Hawaii	2,306,804	0	2,306,804	2,197,040
Idaho	4,147,528	530,575	4,678,103	1,814,065
Illinois	21,279,818	482,711	21,762,529	11,555,130
Indiana	13,751,167	566,866	14,318,033	5,919,464

See footnote at end of table.

TABLE P-6.—CHILD SUPPORT COLLECTIONS AND EXPENDITURES (AUG. 1, 1975–JUNE 30, 1978)—Continued

	Total AFDC collections	Total non-AFDC collections	Total collections	Total expenditures
Iowa	$21,391,581	$1,142,481	$22,534,062	$5,042,292
Kansas	8,900,426	137,387	9,037,813	2,719,822
Kentucky	4,508,784	147,912	4,656,696	3,406,892
Louisiana	7,323,559	15,142,836	22,466,395	12,156,062
Maine	6,758,667	340,447	7,099,114	2,167,596
Maryland	21,726,092	2,252,255	23,978,347	9,907,846
Massachusetts	69,126,686	0	69,126,686	10,998,926
Michigan	189,783,376	142,574,757	332,358,133	41,917,029
Minnesota	30,397,212	8,662,939	39,060,151	20,263,262
Mississippi	1,504,305	53,064	1,557,369	1,975,106
Missouri	2,575,463	105,746	2,681,209	3,446,843
Montana	1,301,625	504,884	1,806,509	1,293,247
Nebraska	2,650,961	397,549	3,048,510	1,988,527
Nevada	690,861	2,864,438	3,555,299	2,389,357
New Hampshire	4,463,296	0	4,463,296	776,520
New Jersey	56,010,361	142,170,605	198,180,966	41,817,860
New Mexico	2,449,262	418,817	2,868,079	2,813,825
New York	88,924,055	170,026,854	258,950,909	122,614,515
North Carolina	8,299,872	1,300,745	9,600,617	8,384,144
North Dakota	2,336,671	274,130	2,610,801	924,288

Ohio	56,478,837	416,102	56,894,939	16,867,400
Oklahoma	2,956,827	736,338	3,693,165	5,013,075
Oregon	17,880,983	120,859,910	138,740,893	17,024,220
Pennsylvania	63,534,240	385,716,739	449,250,979	32,342,088
Rhode Island	8,379,815	42,284	8,422,099	2,133,547
South Carolina	2,273,007	195,615	2,468,622	1,633,802
South Dakota	2,243,801	96,458	2,340,259	2,390,886
Tennessee	4,736,392	5,467,273	10,203,665	3,332,810
Texas	15,031,586	2,647,333	17,678,919	21,151,866
Utah	9,312,391	1,368,062	10,680,453	4,868,448
Vermont	2,600,143	351,566	2,951,708	1,339,273
Virginia	14,944,829	32,236	14,977,065	9,530,136
Washington	43,280,855	15,394,371	58,675,226	16,988,991
West Virginia	1,621,596	69,087	1,690,683	3,240,634
Wisconsin	44,116,125	6,704,802	50,820,927	15,933,918
Wyoming	772,785	150,386	923,171	273,128
Guam	35,479	0	35,479	143,918
Puerto Rico	143,565	375,911	518,476	1,686,804
Virgin Islands	305,242	26,323	331,565	920,940

[1] Includes $63 million in fiscal year 1976 of unreported collections and payments made directly to families.

Source: Office of Child Support Enforcement, Department of Health, Education, and Welfare.

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The child support collections are also affecting the AFDC rolls. The following table shows the child support collections included in AFDC payments, by States, for the month of May, 1978. In June 1978, the number of AFDC recipients dropped to less than 10.6 million, the lowest number of recipients on the rolls since October 1971.

This reduction can certainly be attributed in large measure to the two programs which reduce or eliminate financial dependency on welfare. These are the child support enforcement program through collection of child support for all families and the work incentive program through placing AFDC recipients in employment.

In fiscal year 1976 paternity was established by the courts for 14,700 children, in the next 12 months for an additional 53,100 children, and in the last 9 months for an additional 99,800 children. There were 75,000 support obligations established in fiscal year 1976 most of them as a result of court action. In the next 12 months an additional 146,100 obligations were established and in the subsequent 9 months another 340,700. During the same 32-month period 918,900 absent parents were located. The following table shows the number of parents located, paternities established, and obligations established by States for the first 32 months of the Child Support Enforcement program for the period August 1, 1975–March 30, 1978.

P–7.—CHILD SUPPORT COLLECTIONS INCLUDED IN AFDC PAYMENTS, MAY 1978

State	Child support collections	AFDC payments	Percent collections are of AFDC payments
Total	$39,696,395	$884,834,059	4.5
Alabama	(1)	6,507,317	.....
Alaska	(1)	[2] 1,383,765	.....
Arizona	65,280	2,419,378	2.7
Arkansas	162,594	4,269,105	3.8
California	5,989,020	151,272,153	4.0
Colorado	267,956	5,818,182	4.6
Connecticut	848,171	13,550,428	6.3
Delaware	[2] 118,000	2,325,533	5.1
District of Columbia	58,538	7,617,417	.8
Florida	424,557	11,786,775	3.6
Georgia	107,723	8,655,827	1.2
Guam	(1)	259,856	.....
Hawaii	250,070	6,792,199	3.7
Idaho	137,765	1,711,216	8.1
Illinois	764,899	57,514,910	1.3
Indiana	714,156	9,976,880	7.2
Iowa	572,431	8,921,238	6.4
Kansas	248,307	6,158,796	4.0

See footnotes at end of table.

P–7.—CHILD SUPPORT COLLECTIONS INCLUDED IN AFDC PAYMENTS, MAY 1978—Continued

State	Child support collections	AFDC payments	Percent collections are of AFDC payments
Kentucky	(1)	$10,368,238	.....
Louisiana	$351,503	8,347,074	4.2
Maine	298,326	4,270,822	7.0
Maryland	795,659	13,737,348	5.8
Massachusetts	2,219,060	39,988,492	5.5
Michigan	6,433,694	66,253,544	9.7
Minnesota	1,245,245	13,537,759	9.2
Mississippi	[2] 10,379	2,459,632	.4
Missouri	374,377	12,269,651	3.1
Montana	[2] 36,000	1,210,776	3.0
Nebraska	186,242	3,250,070	5.7
Nevada	43,137	700,600	6.2
New Hampshire	203,259	1,820,212	11.2
New Jersey	1,849,206	[2] 40,459,160	4.6
New Mexico	82,448	2,593,913	3.2
New York	3,317,275	141,701,942	2.3
North Carolina	702,164	11,613,767	6.0
North Dakota	82,271	1,253,214	6.6
Ohio	1,779,745	36,271,037	4.9
Oklahoma	110,377	6,439,238	1.7
Oregon	931,294	12,524,610	7.4
Pennsylvania	2,698,657	[2] 60,306,321	4.5
Puerto Rico	(1)	2,116,153	.....
Rhode Island	[2] 242,309	4,650,404	5.2
South Carolina	120,832	4,292,603	2.8
South Dakota	(1)	1,481,890	.....
Tennessee	275,173	6,265,406	4.4
Texas	438,193	10,242,344	4.3
Utah	[2] 350,000	3,241,447	10.8
Vermont	94,695	1,729,208	5.5
Virgin Islands	(1)	138,184	.....
Virginia	[2] 150,504	11,202,999	1.3
Washington	1,549,134	14,713,575	10.5
West Virginia	99,139	4,190,566	2.4
Wisconsin	1,867,214	21,695,105	8.6
Wyoming	29,417	555,780	5.3

[1] Data not reported by Alabama, Alaska, Kentucky, and South Dakota; reporting waived for Guam, Puerto Rico, and the Virgin Islands.
[2] Estimate.

Source: Department of Health, Education, and Welfare.

TABLE P-8.—NUMBER OF PARENTS LOCATED, PATERNITIES ESTABLISHED, AND OBLIGATIONS ESTABLISHED (AUG. 1, 1975-MAR. 30, 1978)

	Parents located	Paternity established	Obligations established
Totals	918,872	167,566	561,761
Alabama	17,776	7,453	11,631
Alaska	3,608	26	313
Arizona	13,178	6,652	1,685
Arkansas	7,820	2,924	7,829
California	85,168	18,040	62,055
Colorado	12,968	1,457	11,267
Connecticut	17,158	4,853	51,866
Delaware	973	(1)	(1)
District of Columbia	2,079	219	509
Florida	55,117	8,384	20,392
Georgia	38,399	8,273	17,048
Hawaii	10,006	780	1,890
Idaho	4,185	220	1,902
Illinois	22,280	5,664	36,567
Indiana	8,828	1,370	3,210
Iowa	2,162	841	2,135
Kansas	12,743	2,302	13,703
Kentucky	4,005	430	1,213
Louisiana	6,447	1,554	8,259
Maine	(1)	37	(1)
Maryland	34,708	7,706	12,540
Massachusetts	7,448	2,289	21,451
Michigan	36,217	5,775	10,856
Minnesota	4,281	1,525	4,109
Mississippi	1,669	289	499
Missouri	(1)	(1)	(1)
Montana	4,410	53	127
Nebraska	2,746	(1)	(1)
Nevada	3,092	260	1,793
New Hampshire	922	62	190
New Jersey	42,963	13,419	31,767
New Mexico	3,306	250	2,608
New York	167,029	15,554	29,950
North Carolina	33,847	11,704	20,000
North Dakota	1,464	276	707

See footnote at end of table.

TABLE P-8.—NUMBER OF PARENTS LOCATED, PATERNITIES ESTABLISHED, AND OBLIGATIONS ESTABLISHED (AUG. 1, 1975–MAR. 30, 1978)—Continued

	Parents located	Paternity established	Obligations established
Ohio	67,418	10,408	32,126
Oklahoma	2,768	99	2,134
Oregon	80,326	2,907	524
Pennsylvania	15,106	6,234	41,118
Rhode Island	1,885	155	6,068
South Carolina	5,434	1,206	1,750
South Dakota	45	244	11,207
Tennessee	4,858	5,352	5,126
Texas	5,248	324	19,066
Utah	7,378	137	6,529
Vermont	1,562	336	2,077
Virginia	6,425	1,905	4,019
Washington	27,242	676	24,100
West Virginia	(1)	(1)	(1)
Wisconsin	14,800	6,877	13,838
Wyoming	4,874	46	906
Guam	(1)	(1)	(1)
Puerto Rico	3,664	9	790
Virgin Islands	837	10	312

[1] Never reported.

Source: Office of Child Support Enforcement, Department of Health, Education, and Welfare.

Such success, as gratifying as it is, has, however, also resulted in a backlog of cases in courts of some States.

The Federal Child Support Enforcement Office made an informal telephone survey of the States in April 1976 in which it determined that more than 40,000 cases were pending in the various States. This number has grown significantly since that time as the child support program has been more fully implemented.

The committee is cognizant of the recently published revision of child support regulations authorizing Federal funding of certain additional court expenses. They were a step in the right direction, but are of little benefit in some States in easing the increasing court backlog of cases involving paternity determinations and establishing support obligations.

Committee provision

The committee is concerned that the child support program may be seriously undermined if the current large backlog of cases is allowed

to continue to grow. The committee is convinced that the situation can be improved if the States are enabled to use their Federal matching funds to compensate judges and other court personnel for services related to the child support program. The committee amendment would allow matching for compensation of judges and other court personnel only to the extent that the compensation is clearly identifiable with and directly related to services performed under the child support program. In addition, in order to assure that the new Federal dollars will result in increased court actions, the bill would provide matching only for amounts expended by a State which are greater than were expended by the State in calendar year 1976. The bill would allow the State to pay the compensation directly to the courts. Matching would be available for expenditures beginning January 1, 1979.

7. Public Assistance Expenditures in Puerto Rico, Guam, and the Virgin Islands

(SECTIONS 607–609 OF THE BILL)

Present law

Under existing law there is a dollar ceiling on Federal matching for costs of cash assistance, administration and social services provided under the programs of aid to families with dependent children and aid to the aged, blind, and disabled in the jurisdictions of Puerto Rico, Guam, and the Virgin Islands. The annual ceiling is $24 million for Puerto Rico, $1.1 million for Guam, and $0.8 million for the Virgin Islands. These limits have been in effect since 1972. In addition, these jurisdictions are limited to 50 percent Federal matching, whereas the States may receive from 50 to 83 percent Federal matching, depending on State per capita income.

The average payment in May 1978 for AFDC recipients was $11.87 in Puerto Rico, $53.95 in Guam, and $39.74 in the Virgin Islands, compared to a U.S. average of $83.24 per recipient. Average payments for the aged in these jurisdictions were $20.23 in Puerto Rico, $72.40 in Guam, and $57.88 in the Virgin Islands, compared to the average federally administered SSI payment of about $124.

Committee provision

The committee believes that these funding restrictions have had the effect of maintaining an undesirably low payment level for all categories of recipients in these jurisdictions. The committee amendment would enable payment levels to be raised for needy families with children and for the aged, blind, and disabled by increasing the Federal matching percentage from 50 percent to 75 percent, while tripling the dollar limitations. This will permit the territories to double the size of their federally matched assistance under these programs with no increase in non-Federal matching. The amounts for each jurisdiction under present law and under the committee provision are shown in the table below. This provision would be effective on October 1, 1978.

Table P-9.—FEDERAL FUNDS FOR ASSISTANCE PROGRAMS

	Present law (50 percent Federal matching)	Committee bill (75 percent Federal matching)
Puerto Rico	$24,000,000	$72,000,000
Virgin Islands	800,000	2,400,000
Guam	1,100,000	3,300,000

In addition, the committee amendment would treat the Northern Marianas in a manner comparable with Puerto Rico, the Virgin Islands, and Guam. Specifically, the committee amendment would establish in the Northern Marianas the programs of aid to the aged, blind, and disabled, AFDC and medicaid subject to the same matching and a comparable overall limit on Federal funding ($570,000) as is provided for in the case of other territories.

V. BUDGETARY IMPACT OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970 and sections 308 and 403 of the Congressional Budget Act, the following statements are made relative to the costs and budgetary impact of H.R. 13511 as reported.

Budget effect of the tax provisions

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 13511, as amended by the committee. The committee estimates that the budget effect of the tax provisions of this bill for fiscal years 1979–1983 is as shown in the following tabulation.

The Treasury Department agrees with this statement. Part III of this report contains a more detailed statement of the budget effect of the tax provisions of the bill as reported.

Summary of Estimated Budget Effects of the Tax Provisions of H.R. 13511, as Reported by the Committee, Fiscal Years 1979–83

[In millions of dollars]

Major category	Fiscal year receipts				
	1979	1980	1981	1982	1983
Tax reductions and revisions:					
Individual reduction	−8, 965	−17, 782	−20, 210	−23, 364	−26, 975
Business reduction	−2, 243	−4, 984	−7, 213	−8, 845	−9, 451
Capital gains reduction	−374	−2, 685	−2, 963	−3, 155	−3, 370
Individual reduction	−321	−2, 560	−2, 822	−3, 000	−3, 209
Business reduction	−53	−125	−141	−155	−170
Minimum and maximum tax provisions	−78	−135	−158	−181	−207
Total, tax reductions and revisions	**−11, 660**	**−25, 586**	**−30, 544**	**−35, 545**	**−40, 003**
Temporary tax reduction extensions	**−8, 894**	**−16, 480**	**−19, 517**	**−23, 774**	**−25, 885**
GRAND TOTAL, TAX REDUCTIONS, REVISIONS, AND EXTENSIONS	**−20, 554**	**−42, 066**	**−50, 061**	**−59, 319**	**−65, 888**

Budget Effect of Provisions Related to Social Security Act Programs

The Committee estimates that the costs of the provisions relating to Social Security Act programs over fiscal years 1979–1983 will be shown in the following tabulation:

[In millions of dollars]

Section of bill	Cost impact in fiscal year—				
	1979	1980	1981	1982	1983
601: Fiscal relief [1]	350	−50	−50	−50	−50
602: Social services	300				
603: AFDC management information	+7	+7	+8	+8	+8
604: WIN modifications	−43	−55	−60	−65	−70
605: Incentive to report earnings	−23	−24	−26	−28	−30
606: Matching of child support court personnel [2]	(+8)	(+12)	(+13)	(+14)	(+14)
607–609: Territorial assistance programs	+52	+52	+52	+52	+52
Total [2]	+643	−70	−76	−83	−90

[1] Fiscal relief estimate is net amount of payment less savings from incentive to reduce errors.

[2] Amounts shown for matching of child support court personnel represents gross costs. The committee assumes that any costs incurred will actually be more than offset by increased collections of child support. Accordingly these amounts are not included in the total.

The committee has not at this time filed its allocation report pursuant to section 302 of the Congressional Budget Act because of the necessity of incorporating the results of a pending conference in that report. However, the amounts shown above are consistent with the amounts allowed in the second budget resolution for fiscal year 1979 and will be consistent with the allocation report when filed.

The estimates of the committee as shown in the above table differ in some respects from the estimates of the Congressional Budget Office. For section 601, the Congressional Budget Office estimates a somewhat smaller reduction in error rates (and therefore a smaller net cost) than the committee. In addition, the CBO believes that the improvement in error rates will decline over time. The committee believes that the States will maintain the gains which are stimulated by this fiscal relief payment.

The committee's estimates for the sections relating to AFDC and child support differ significantly from CBO. The committee estimates of the cost and savings of aid to families with dependent children rely heavily on estimates provided by the Administration. The committee notes, however, that this is an area in which estimates are based on assumptions as to future behavior of States and individuals for which little if any reliable guidelines for prediction exist. In particular, the Congressional Budget Office estimate with respect to the impact of the work incentive program shows no savings (in fact, it shows the provision as adding costs over existing law). The committee believes that this represents a judgmental decision on the part of CBO estimators as to whether or not a particular new legislative initiative will be effective. The committee believes that its judgment and that of the agency

charged with administering the program provide a better guide for developing an estimate of the potential savings to be realized.

New Budget Authority

Refundable tax credit items in the committee bill

Under previous precedents of the Congressional Budget process, refundable tax credits had been treated as revenue reductions. The committee notes that a modification in this treatment has been adopted this year. To the extent that refundable tax credits result in a liability on the part of the Treasury toward the taxpayer at the time he files his return, they actually require the writing of a Treasury check against the general fund. This technically constitutes an outlay from the Treasury which under the Constitution requires an appropriation (the permanent appropriation for refunding overpaid taxes applies). The congressional budget process was therefore modified to treat tax credits which actually require the writing of a check against the Treasury as outlays rather than as revenue reductions. Two such credits are included in this bill.

(*1*) *The refundable bondholder taxable option.*—This is estimated to have a fiscal year 1979 "outlay" impact of approximately $10 million. This is consistent with the second budget resolution and will be accommodated within the Committee's section 302 report, when filed.

(*2*) *The refundable aspects of the earned income tax credit.*—This provision will, under the bill, be substantially reflected in withholding, substantially reducing the "outlay" impact of the prior provision which was entirely claimed on the annual tax return. However, the Committee estimates that there will be a small outlay in fiscal 1979 which will be accommodated within the section 302 report when filed. The increase in outlays will be $994 million in fiscal year 1980, $729 million in fiscal 1981, $699 million in fiscal 1982, and $670 million in fiscal 1983. Outlays for public assistance will be reduced by $42 million in fiscal year 1979, $181 million in fiscal year 1980, $190 million in fiscal 1981, $199 million in fiscal 1982, and $203 million in fiscal 1983.

Consultation with Congressional Budget Office on Budget Estimates New Budget Authority, and on Tax Expenditure Estimates

In accordance with section 403 of the Budget Act, the committee has received the report, which appears below, on the budget effects of the bill from the Director of the Congressional Budget Office.

With respect to the estimates on tax expenditures, the committee does not agree with the Congressional Budget Office with respect to the graduated tax rate structure for the corportae income tax. The committee believes that the graduated tax rate becomes part of the normal tax structure, departures from which are considered as tax expenditures.

CONGRESSIONAL BUDGET OFFICE,
U.S. CONGRESS,
Washington, D.C., October 1, 1978.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washintgon, D.C.

DEAR MR. CHAIRMAN: In accordance with the Budget Act, the Congressional Budget Office has examined H.R. 13511 which would pro-

vide general tax reductions, expand the earned income credit, make a number of structural changes in the tax law, and amend several welfare provisions of federal law.

For the purposes of Section 308 of the Budget Act, the Congressional Budget Office has estimated the increased outlays and budget authority and the increase in tax expenditures over the next five fiscal years as:

[In millions of dollars]

	Fiscal years—				
	1979	1980	1981	1982	1983
Outlays and budget authority	520	1, 344	1, 294	1, 254	1, 159
Tax expenditures	1, 689	6, 505	11, 104	16, 234	18, 160

For the purposes of Section 403 of the Budget Act, the Congressional Budget Office has estimated the cost (revenue reductions and budget outlays) of carrying out the bill over the next five fiscal years as:

[In millions of dollars]

	Fiscal years—				
	1979	1980	1981	1982	1983
Cost of carrying out the bill	21, 054	41, 793	50, 302	59, 965	67, 100

The costs vary only slightly from the Committee's and are due to minor estimating differences. They are discussed in detail in the explanatory materials to Tables 2 and 4.

In Table 1, the total cost of the bill is set forth. Table 2 displays the increase in outlays, and accompanying text explains the differences between Committee's and CBO's estimates. Table 3 details the way in which tax expenditures would be affected by the bill. Table 4 sets forth the differences in revenue reductions estimated by the Committee and the Congressional Budget Office.

Sincerely,

ALICE M. RIVLIN.

Table 1.—Total Cost of H.R. 13511 as Reported by Senate Finance Committee: Fiscal Years, Millions of Dollars

	1979	1980	1981	1982	1983
Outlays	520	1, 344	1, 294	1, 254	1, 159
Revenue loss	20, 534	40, 449	49, 008	58, 711	65, 941
Total	**21, 054**	**41, 793**	**50, 302**	**59, 965**	**67, 100**

Table 2.—Increase in Outlays and Budget Authority Provided by H.R. 13511 as Reported by Senate Finance Committee: Fiscal Years, Millions of Dollars

	1979	1980	1981	1982	1983
Welfare provisions	414	137	137	113	121
Earned income credit	106	1,207	1,157	1,140	1,038
Total	**520**	**1,344**	**1,294**	**1,254**	**1,159**

Explanation of Estimates of Welfare Provisions of H.R. 13511 as Reported by the Senate Finance Committee

There are six welfare provisions in this bill.

1. *AFDC Management Information System.*—This provision would provide incentives for the states to develop and operate computerized management information systems for the AFDC.

2. *Federal Matching for Child Support Duties Performed by Court Personnel.*—This provision would extend federal matching to the services provided by judges and other support and administrative personnel of the courts who perform functions under the IV D Child Support program.

3. *Work Incentive Program.*—This provision would require AFDC recipients, who are not excluded from WIN registration by law, to register for and participate in employment search activities as a condition of continuing eligibility for AFDC.

4. *Incentives to Report Earnings.*—This provision would provide an incentive to report income in AFDC by specifying that there would be no disregard of any earned income which the recipient had not reported to the state agency.

5. *Treatment of Territories Under Social Security Assistance.*—This provision would increase the federal matching rate from 50 percent to 75 percent for assistance to the aged, blind, and disabled, and to families with dependent children in Guam, Puerto Rico, and the Virgin Islands. The overall dollar limitations are also increased.

6. *Fiscal Relief for State and Local Welfare Costs.*—This provision provides for the allocation of up to $500 million on the basis of a two part formula. Half the sum would be allocated on the basis of state AFDC expenditures for December 1976. The second part of the allocation formula compares error rates both with past numbers and with target numbers.

Cost Estimates of the Welfare Provisions of H.R. 13511: Fiscal Year, Millions of Dollars

Provision:	1979	1980	1981	1982	1983
1	9.0	49.1	29.2	−6.2	−6.2
2	8.5	11.8	12.7	13.5	14.3
3	45.0	81.4	86.2	91.4	96.6
4	−16.0	−26.0	−28.0	−30.0	−32.0
5	52.6	52.6	52.6	52.6	52.6
6	315.0	−32.0	−16.0	−8.0	−4.0
Total	**414.1**	**136.9**	**136.7**	**111.3**	**121.3**

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The costs of these provisions fall in budget functions 500, 550, and 600.

1. Additional Federal Funding Under Aid to Families with Dependent Children Programs for Certain Mechanized Claims Processing and Information Retrieval Systems

This amendment provides federal matching funds for states choosing to install or update computer systems to handle claims processing and information retrieval for their AFDC programs. Since all states have computer facilities, the estimate only takes account of federal expenditures for updating and extending these facilities together with expenditures for the operation of the new parts of the system. The fiscal year 1979 cost would be relatively low due to time lags involved in writing regulations and approving state plans. Fiscal years 1980 and 1981 would be high cost years for this provision as states purchased and installed their new computer systems, and cost savings would occur in fiscal year 1982 and fiscal year 1983 as the result of staff time reductions and more efficient services.

Fiscal years:

1979	9.0
1980	49.1
1981	29.2
1982	−6.2
1983	−6.2

2. Payment to States for Compensation of Court Perosnnel in Child Support Cases

This provision would grant compensation to states for judges and other court personnel who perform services directly related to child support enforcement. The estimates of this provision were developed by the Department of Health, Education, and Welfare. For fiscal year 1979, the HEW estimates were reduced by a fourth to reflect delayed implementation.

Fiscal years:

1979	8.5
1980	11.8
1981	12.7
1982	13.5
1983	14.3

3. Implementation of Work and Training Requirements Under Aid to Families With Dependent Children Programs

Currently, all AFDC recipients (except those specifically exempted, e.g., children, those already working full-time, mothers with children under six, those who are sick, etc.) are required to register for WIN.

This provision would essentially extend the WIN requirement of AFDC eligibility to include a continuing job search for those not specifically exempted. In addition, in order to facilitate the new job search requirement, this amendment would require the states to provide support services such as child care and transportation under a program of federal matching payments.

This provision would have both costs and savings.

Costs: Costs would result from the supportive services such as child care and transportation provided to WIN participants.

Savings: Savings due to this provision would occur if people are placed in jobs through the WIN program and as a result have lower AFDC payments.

The Congressional Budget Office estimates that the current net cost of this provision for a full year would be $76.8 million.

This includes costs of $131.4 million and savings of $54.6 million.

This estimate assumes implementation of this provision on March 1, 1979. The fiscal year 1979 costs are, therefore, equal to about seven-twelfths of the annual total.

A more extensive CBO analysis of this provision is included in CBO's cost estimate of H.R. 7200 as reported by the Senate Finance Committee.[1]

Fiscal years:	
1979	45.0
1980	81.4
1981	86.2
1982	91.4
1983	96.6

4. Incentive to Report Earned Income Aid to Families with Dependent Children Recipients

This provision stipulates that unless all earned income is reported accurately and in a timely manner, the AFDC recipient will not be eligible for the income disregard. The estimated cost savings for this provision is based on the Department of Health, Education, and Welfare's actual reported error cost in 1976 of $97.5 million resulting from AFDC overpayments due to income date reporting. The Department indicated that over 20 percent of this could be traced to the nonreporting of income. In estimating this cost savings, it was assumed a small portion of error would not be caught. To allow for start-up delay, it was assumed that the provision would effectively cover two-thirds of fiscal year 1979.

Fiscal years:	
1979	−16.0
1980	−26.0
1981	−28.0
1982	−30.0
1983	−32.0

5. Increase in Amount of Dollar Limitations Under Social Security Assistance Programs to the Trust Territories (Programs in Puerto Rico, the Virgin Islands, Guam, and the Northern Mariana Islands)

The cost estimate for these sections reflects the increase in federal dollar limitations available for assistance to the aged, blind, and disabled and to families with dependent children in Puerto Rico, Guam, the Virgin Islands, and the Northern Mariana Islands as well as the

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[1] Public Assistance Amendments of 1977, Report of the Committee on Finance, U.S. Senate, H.R. 7200, November 1, 1977, pp. 135–137.

reduction in the required state matching level from 50 percent to 25 of the federal funds.

It is assumed that Puerto Rico, Guam, and the Virgin Islands will meet their 25 percent matching requirement for the maximum amount since the dollar amounts are the same as those they are presently contributing under the 50 percent match.

Fiscal years:	
1979	52.6
1980	52.6
1981	52.6
1982	52.6
1983	52.6

6. Fiscal Relief for State and Local Welfare Costs

Purpose

To provide fiscal relief for state and political subdivisions with respect to the costs for certain welfare programs.

Basis for estimate

This bill would provide for up to $500 million fiscal relief to states as soon after March 31, 1979 as possible. The maximum allocation of the funds to states would be calculated such that each state's proportion of the $500 million is an average of its proportion of AFDC costs for December 1976 and a proportion based on the revenue sharing formula. The payments made to states would be percentages of these maximums which are determined as follows: If a state has under a 4 percent error rate in the period it would get its maximum payment. If the state has over a 4 percent error rate it would get a percentage of the maximum based on the improvement it had made in its error rate from either the six month base period beginning July 1, 1975 or beginning January 1, 1975 (whichever has the greatest error). The formula for the proportion of the maximum received by these states is:

Error rate in the base period—Error rate in the test period

Error rate in the base period—4 percent where the test period is October 1, 1978 to March 31, 1979.

Any state at or below an error rate of 5 percent during its test period would get at least 90 percent of its basic apportionment and any state at or below an error rate of 6 percent would get at least 75 percent of its basic apportionment. States whose error rates in the test period exceed both 6 percent and the base period error rate, would receive no payments.

The Congressional Budget Office estimate of a net cost of $315 million for fiscal year 1979 is the net result of the following components:

a. $350 million in payments under the formula. It is estimated that out of the $500 million, only $350 million would be paid to the states in 1979 since many states are not expected to be able to reduce their error rates below 4 percent by that time, and, hence, would receive less than their maximums. To estimate the difference below the maximum, CBO used data on current error rates obtained from the Department of Health, Education, and Welfare.

b. An estimated $11 million for the federal share of administrative expenditures necessary to accomplish a reduction in error rates.

c. Estimated savings of $46 million from reducing the error rate. This occurs because most errors are overpayments or payments to ineligibles, rather than underpayments.

CBO assumes that the amount of net savings (savings less administrative costs) induced by these provisions will decline in the years beyond fiscal year 1979.

Fiscal years:	
1979	315.0
1980	−32.0
1981	−16.0
1982	−8.0
1983	−4.0

Explanation of Estimates of Earned Income Credit Amendment as Reported by Senate Finance Committee

The bill makes the earned income credit permanent, and increases the amount of the credit to 12 percent of the first $5,000 of earned income: this results in a maximum credit of $600. In recognition of the unusually high cost of living in Alaska and Hawaii, this dollar amount is adjusted upward by the ratio of the Office of Management and Budget official poverty line for any non-contiguous state to the poverty line for the 48 contiguous states, if this ratio is 15 percent or greater. For example, the official poverty line for Alaska currently is 25 percent greater than the poverty line for the 48 contiguous States. Thus, for residents of Alaska, the earned income credit would be equal to 12 percent of the first $6,250 of earnings, for a maximum of $750. For this purpose, an individual will be treated as a resident of a state if he maintains a household in that State and is physically in that State for more than 210 days during the taxable year.

The bill revises the income limitation on the credit, both to take account of the increase in the amount and to simplify the calculation of the credit. Under current law, the actual amount of the allowable credit is reduced by one dollar for each ten dollars by which adjusted gross income (or, if greater, earned income) exceeds $4,000. Under the bill, however, the allowable earned income credit for any taxable year will not be more than the difference between $600 and 12 percent of the income over $6,000, subject to adjustment for residents of non-contiguous states consistent with the higher credit level.

The bill provides that eligible individual may elect to receive advance payment of the earned income credit from their employers. Any individual who receives advance payments during a calendar year would be liable for the excess of such payment over the actual amount of the credit, which cannot be determined until the end of the year. Conversely, individuals whose advance payments for a year are less than the actual amount will be credited with the excess of the actual credit over the advance payments.

The bill repeals the provision in current law requiring that the credit be disregarded for purposes of cash or in-kind Federal or Federally-aided assistance provisions. The committee believes that the credit should be treated as earned income, and the bill amends the provisions of the Social Security Act specifically to provide that

the credit is treated as earned income in the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs.

This last provision will result in some savings from these programs. Also, the Department of Agriculture would have discretion to treat the credit as income in calculating eligibility for food stamps. The Congressional Budget Office cost estimates assume that this credit will be counted as income thus result in a savings. If the Department of Agriculture does not exercise this discretion, then outlays and budget authority would be increased by the amount shown below as a savings in the food stamp program.

Based on simulation in CBO's model of the earned income credit population, the increases in outlays and budget authority in millions of dollars are:

	Fiscal years—				
	1979	**1980**	**1981**	**1982**	**1983**
Modify credit	148	1,375	1,335	1,327	1,229
Simplify credit		13	12	12	12
Savings in AFDC	−17	−71	−75	−79	−83
Savings in food stamps	−25	−110	−115	−120	−120
Total	**106**	**1,207**	**1,157**	**1,140**	**1,038**

These estimates differ from the Committee's for four reasons. First, the model on which the total costs are simulated have minor data differences. Second, the economic assumptions on which the estimates are made differ. Third, calendar year liabilities are allocated to fiscal years in a slightly different fashion.

The other difference results from a difference in budgetary convention and requires some explanation. The earned income credit allows low income workers to claim a proportion of their wages as a credit on their tax returns. It is a refundable tax credit. Thus, if the credit is less than the income tax liability, it reduces the income tax. But if the credit is greater than the income tax, the Treasury pays the difference to the worker. Tax returns are filed only after the end of the year, and the worker does not receive any of the credit until the tax return is filed. For example, earned income credits on wages paid in 1979 will not be applied to tax liabilities or paid to workers until early 1980 when tax returns are filed.

Under the bill, the earned income credit would be expanded. Also, to satisfy Congressional desires that the worker not have to wait until the tax return is filed in the following year, beginning in Jully 1979, the credit would be made available, through "negative withholding," to workers as the wages are earned. Under negative withholding, the worker's employer would increase the worker's pay check by the amount of the credit due on the wages being paid. The Treasury would reimburse the employer for making this payment by allowing the em-

ployer to keep withheld taxes that the employer would otherwise pay the federal government. This reimbursement would be made from, in the order listed, (1) withheld income taxes, (2) withheld social security taxes, (3) social security taxes imposed on the employer, and (4) other taxes owed by the employer.

Under this plan, some credits that, under existing law, would be paid in the early part of calendar year 1980 (fiscal year 1980) would be accelerated and paid, through negative withholding, to workers in calendar year 1979 before the close of fiscal year 1979. Also, some of the credits that, under existing law, would be made from the United States Treasury would, under the bill, be made by the employer to the employee on behalf of the Treasury. The employer would be reimbursed by retaining taxes that would otherwise be remitted to the Treasury.

In making its cost estimate for the earned income credit, the Congressional Budget Office has assumed that neither the change in timing nor the change in the identity of the payor will effect a change in the character of the payment for the budgetary convention adopted in the First Concurrent Resolution on the Budget for Fiscal Year 1979. Thus, credits which do not exceed liability for income tax have been treated as reductions of revenue, but credits which are paid from other withheld taxes have been treated as outlays.

When all of these differences are taken into account, the full cost estimates (both revenue reduction and increased outlays) compare in millions of dollars as follows:

CBO:	
Fiscal years:	
1979	176
1980	1,682
1981	1,541
1982	1,517
1983	1,402
Committee:	
Fiscal years:	
1979	110
1980	1,986
1981	1,642
1982	1,574
1983	1,512

Table 3.—Effect of H.R. 13511 on the Level of Tax Expenditures: Fiscal Years, Millions of Dollars

Provision	Fiscal Year—				
	1979	1980	1981	1982	1983
Repeal of gas tax deduction	−409	−1, 040	−1, 102	−1, 158	−1, 238
Increase credit for political contributions	(1)	16	26	16	16
Earned income credit	23	294	194	178	161
Credit for the elderly	104	278	278	278	178
Amortization of low income housing	(1)	(1)	11	19	24
Deferred compensation plans	(1)	(1)	(1)	(1)	(1)
Exemption for the disabled	121	248	379	519	546
IRA pension plans	6	18	29	39	49
Contributions to other pension plans	144	352	425	487	536
Employer educational assistance	8	28	31	35	39
Corporate rates on first $100,000 of income	634	1, 469	1, 608	1, 762	1, 929
Changes in the investment tax credit:					
10 percent rate made permanent	(1)	(1)	2, 071	5, 201	6, 283
90 percent limitation	129	441	872	1, 015	782
Pollution control	10	34	85	156	211
Farm structures	53	33	22	24	26
Cooperatives	46	33	35	37	39
Lessors of railroad cars	(1)	5	(1)	(1)	(1)
Breeding and draft horses	6	16	17	19	21

GSOP investment credit [2]	(1)	(1)	(1)	(1)	(1)
Exchange of personal residence	(1)	(1)	(1)	(1)	(1)
Advance refunding of industrial development bonds	(1)	(1)	9	9	9
Targeted jobs and WIN credit	178	651	882	913	504
Industrial development bonds	(1)	10	43	78	104
Remove IDCs from minimum tax	51	61	73	84	97
Broaden asset depreciation range	231	919	1, 723	2, 337	2, 812
Contributions in aid of construction for gas and electric utilities	(1)	50	100	100	100
TRASOPs	(1)	(1)	178	446	545
Credit for taxable bonds	(1)	30	174	320	467
Capital gains:					
Increase exclusion to 70 percent of gain	168	2, 230	2, 512	2, 897	3, 473
Exclusion of portion of gain on certain sales of residences	138	295	325	357	393
Repeal alternative tax	−20	−133	−143	−154	−166
Minimum tax provisions	27	111	126	142	160
Postpone carryover basis	36	93	162	133	110
Alternative minimum tax	(1)	−1, 803	−1, 763	−1, 939	−2, 133
Repeal existing minimum tax	(1)	1, 566	1, 722	1, 894	2, 083
Total	**1, 689**	**6, 505**	**11, 104**	**16, 234**	**18, 160**

[1] Less than $5,000,000.

[2] While the tax expenditure increase for this provision is estimated at less than $5 million annually, the long-run increase could be much larger.

Note: Negative numbers indicate a reduction of tax expenditures and are revenue gains. Positive numbers are increases in tax expenditures and are revenue losses.

Source: Congressional Budget Office based on estimates made by Treasury Department and the Joint Committee on Taxation.

Table 4.—Comparison of Committee's Estimates of Revenue Reductions With Estimates of the Congressional Budget Office: Fiscal Years, Millions of Dollars

	1979	1980	1981	1982	1983
Committee's estimate	−20, 554	−42, 066	−50, 061	−59, 319	−65, 888
CBO estimates differ from committee's:					
Repeal of gasoline tax deduction	−62	−197	−356	−552	−791
Earned income credit	+82	+1, 692	+1, 446	+1, 396	+1, 351
Capital gains		+72	−37	−236	−613
CBO estimates revenue reductions are less than committee's by	+20	+1, 567	+1, 053	+608	−53
CBO's estimates	−20, 534	−40, 499	−49, 008	−58, 711	−65, 941

Comparison of Committee's Estimates of Revenue Reductions With Estimates of the Congressional Budget Office

The estimates for the revenue to be gained from the repeal of the gasoline tax are based on different economic assumptions and estimates about the number of taxpayers who would take the standard deduction rather than itemize their personal deductions.

The earned income credit estimates result from different data bases, economic assumptions, allocations of calendar year accruals to fiscal years, and budgetary conventions. The differing budgetary treatments do not affect total costs, however, but merely whether the item is shown as an outlay or as a revenue reduction. The table below shows the difference in revenue reductions and the amount of it that CBO shows as an outlay. The balance is due to the other factors mentioned and is the difference in total cost.

[In millions of dollars]

	Fiscal years—				
	1979	1980	1981	1982	1983
Difference in revenue reductions	82	1, 692	1, 446	1, 396	1, 351
Amount that CBO will show as an outlay	148	1, 388	1, 347	1, 339	1, 241
Amount by which committee's total cost exceeds CBO's total cost	−66	304	99	57	95

NOTE: Also in years after fiscal year 1979, CBO and the Committee estimate the revenue from capital gains differently. The difference is wholly attributable to the different assumptions about sales induced by the lower tax rates. The CBO estimate agrees with those made by the Department of the Treasury.

VI. REGULATORY IMPACT OF THE BILL AND VOTE OF THE COMMITTEE

A. Regulatory Impact

In compliance with paragraph 5 of rule XXIX of the Standing Rules of the Senate, the following statements are made concerning the regulatory impact of the bill.

Tax Provisions of the Bill

Numbers of individuals and businesses who would be regulated

The bill amends the Internal Revenue Code to provide general tax rate reductions to individual and corporate income taxpayers and makes many adjustments in various sections of the Internal Revenue Code which will affect the tax liabilities of many taxpayers. None of the tax amendments has a regulatory impact on individuals and businesses.

Economic impact of regulation on individuals, consumers and business affected

There is no regulatory impact on individuals, consumers and business, and therefore, there is no economic impact from regulation.

Impact on personal privacy

The bill has no significant impact on the personal privacy of taxpayers.

Determination of the amount of paperwork

The provisions in the bill will affect the amount of paperwork a taxpayer may well have to do, but whether there will be an increase or decrease will vary according to each taxpayer's particular situation.

VII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

VIII. ADDITIONAL VIEWS OF HON. HARRY F. BYRD, JR.

This legislation, as reported by the Finance Committee, provides tax reductions and takes several steps to improve our current tax laws.

In the estate tax law, the committee has agreed to defer until after December 31, 1979, the effective date of the carryover basis provisions which were enacted in 1976. In its deliberations on the 1976 Tax Reform Act, the Senate never considered carryover basis which provides that the property of a decedent, when passed to the decedent's heirs, retains its original cost basis for tax purposes. There were no Senate hearings on this provision.

As written by the conference committee, carryover basis has proved unworkable. This view is virtually unanimous among lawyers, accountants, trustees, and committee staff.

Deferral of carryover basis would give the Congress time to study needed changes and review its full implications. Both the chairman of the Finance Committee, Senator Long, and I, as chairman of the Subcommittee on Taxation and Debt Management, have pledged early hearings on this matter.

For individual taxpayers, the bill provides rate reductions, widening of tax brackets, and increases in the personal exemption and standard deduction. These changes will benefit 65 million taxpayers.

For the business sector and the American economy in general, the bill moves toward establishing much needed incentives for capital formation. At hearings over the past 2 years which I have conducted as chairman of the Subcommittee on Taxation and Debt Management, the subcommittee has found general agreement about the need to encourage capital investment in the American economy. Increases in American productivity are now at a low level, in contrast with sizable gains for our competitors abroad.

This bill seeks to meet the investment and productivity needs of our economy. It liberalizes depreciation allowances, reduces the unproductively high tax on capital gains, and provides for corporate rate reductions.

In addition, the bill establishes a more equitable minimum tax than the current law. It replaces the current add-on minimum tax with an alternative minimum tax. The current minimum tax is in addition to other taxes paid. The Finance Committee bill would require the payment of either the regular tax or the alternative tax, whichever is the higher.

The decisions which the committee has made to encourage capital investment are steps in the right direction, with the potential of increasing American productivity and thus increasing job opportunities.

Although the Finance Committee bill has many desirable features, I find some elements of the bill disturbing, notably the dramatic expansion of the earned income credit. The committee's actions, if

finally enacted into law, will greatly expand the present supplemental income program for certain low-income Americans, in the guise of a tax reduction. It will apply to those who pay no taxes and to those who draw welfare benefits.

Under current law, individuals are entitled to a tax credit of 10 percent of the first $4,000 of earned income, for a maximum credit of $400. The credit is phased out as earned income increases from $4,000 to $8,000.

Earned income credit currently is available to the head of a household, either married or single, who maintains a household for a child who is either under 19 or a student. It is not required that the parent claim the child as a personal exemption. AFDC recipients who furnish more than one-half of the household expenses are eligible for the earned income credit. Therefore, individuals may receive up to 50 percent of their income from AFDC and still receive the credit.

Currently, the credit is paid annually to taxpayers who file tax returns.

The Finance Committee bill increases the amount of the credit to 12 percent of the first $5,000 of earnings for a maximum credit of $600. The credit is reduced by $1.20 for every $10 of income above $6,000, phasing out completely at $11,000. It is to be paid directly to the recipient when he receives his wages.

For the first time, the Federal Government will be providing certain Americans, who earn as much as $11,000 per year, with additional supplemental income. Insufficient consideration was given in the Finance Committee to the relationship of this program to other government assistance programs, particularly food stamps, AFDC, and housing subsidies.

The dramatic increase in the earned income credit can be seen when the Finance Committee action is compared with the House provision.

Currently, the earned income credit has an annual revenue cost of $1.1 billion.

The House made the earned income credit permanent and made certain revisions in it. The estimated additional cost of the House action would be $17 million. The Senate Finance Committee expansion, in contrast, would cost an additional $1.7 billion. This is a hundredfold increase in new costs over the House action.

Under the current program, which the House extended, 5.5 million individuals would receive the credit. The committee bill extends the credit to 8.4 million persons.

Thus, a program scheduled to expire at the end of 1979 would be made permanent and extended to nearly 3 million more persons, with an increase in cost from $1.1 billion to $2.8 billion.

This dramatic expansion of the earned income credit, as a tax reduction measure, is not appropriate. It is a supplemental welfare program. It should be viewed in this broader context.

While introducing the negative income tax concept into the tax law, the committee has structured the benefits to go narrowly to one group of taxpayers, those who have children. It is of no benefit for those taxpayers who are married without children or who are single.

Take for example, two workers each earning an identical income of $6,000 a year. They are paid, on a monthly basis, $500 per month.

Under present law, the income tax withholding for one worker who is married but has no children is $6. The same worker who is married and has two children would have nothing withheld.

Under the Finance Committee earned income credit, using current tax rates, the first worker would continue to have $6 a month withheld. However, the second worker would have $50 added to his paycheck.

Disparities in the effect of the earned income credit highlight the basic difficulties which arise when a supplemental welfare program is inserted into a tax reduction measure without full consideration of its total ramifications.

Furthermore, the expanded earned income credit could have an effect running counter to one of the main purposes of the entire legislation; namely, increasing productivity.

As structured by the committee, because the credit decrease for earnings above $6,000, it reduces the reward for that extra effort by a married or single employee with children which can result in advancement and increased earnings. In many cases it is just such effort which builds up the efficiency and productivity of an industry.

I certainly do not mean to suggest that the proposed earned income credit should be expanded beyond the committee's recommendation in order to eliminate inequities among workers or to remove possible disincentives to hard work.

On the contrary, I am pointing out that the full consequences of this provision have not been adequately considered, and that it should be studied in conjunction with possible revisions in the welfare system.

It is not only in the area of the earned income credit that the Finance Committee has embarked upon the path of establishing additional funding for welfare programs. Under the heading of fiscal relief to State and local governments, the committee has committed an additional $400 million in Federal funding for fiscal year 1979 for welfare costs.

Originally, nine Senators in the Finance Committee voted against this measure, thus defeating it. In a later vote, it was passed by a narrow margin.

The $400 million will be distributed in accordance with a two-factor formula which considers both revenue sharing allotments and AFDC expenditures. Under the formula, 28 percent of the $400 million will go to two States, New York and California; and 45.5 percent will go to five States, New York, California, Illinois, Michigan, and Pennsylvania. Additional expenditures for welfare should not be placed on a tax reduction measure.

But the Finance Committee bill, as a whole, seems to me to be a desirable piece of legislation.

While this legislation could be improved, it provides worthwhile incentives for economic growth and additional job opportunities.

The challenge which faces American government is the need to permit the individual to keep more, not less, of his earnings. Tax reductions and control over Federal expenditures should go hand in hand.

IX. ADDITIONAL VIEWS OF HON. GAYLORD NELSON

In considering the 1978 tax program, Congress and the President were confronted with the problem of providing balanced tax relief for both individual and corporate taxpayers without significantly increasing the budget deficit.

Substantial cuts in individual taxes are necessary to offset the effects of inflation and increasing social security tax payments. On the business side, tax incentives are also necessary to spur investment and growth in production capacity. However, experts differ as to the size and distribution of the tax cut.

As to the size of the cut, the President originally recommended a tax reduction of $25 billion in fiscal year 1979. The House bill provides an overall tax cut of $18.3 billion. The bill as reported by the Finance Committee contains a $20.5 billion tax cut.

With respect to the distribution of tax relief, some economists such as Prof. Robert Eisner believe reductions in social security taxes and corporate rates should take precedence. Others, such as Chairman Miller of the Federal Reserve Board believe the economy would benefit and more jobs would be created by improving the rate of capital recovery for business investment through more rapid depreciation deductions.

In reporting the bill, the Finance Committee attempted to fully compensate individuals for increased social security taxes and partially offset the effects of inflation through substantial rate cuts for all taxpayers with special attention to middle income taxpayers and through expansion of the earned income credit for low income taxpayers. The committee bill distributes over 85 percent of the $14 billion in individual cuts to taxpayers with incomes under $50,000. High income taxpayers receive additional benefits under the committee bill through significant cuts in capital gains rates.

Over all, the committee bill achieves a proper balance in its distribution of benefits to low and middle income individual taxpayers. However, the capital gains cuts in the committee bill are larger than they should be considering the limitations of the entire tax package and the need for equitable distribution. Certainly, the maximum capital gains rate should be reduced, but not to the level accepted by the committee. It would be more appropriate to reduce the maximum rate from the current 49 percent to approximately 28 percent instead of the 21 percent recommended by the committee.

Capital gains reduction

The committee bill would reduce the maximum rate of tax on capital gains from 49.125 percent to 21 percent by increasing the present 50 percent exclusion from gross income fro long-term capital gains to 70 percent and by repealing the existing "add-on" minimum tax as it applies to noncorporate taxpayers.

Many distinguished economists believe that such a substantial cut in capital gains rates would increase capital formation, stimulate the economy, and create more jobs. And I do not challenge the merits of their argument.

However, the committee bill distributes 75 percent of the capital gains cut to taxpayers with incomes over $50,000. The cost of this proposal would amount to some $3 billion in 1979. The following table illustrates this point:

Expanded income (thousands)	Number of returns	Average tax decrease	Percent of total distribution
Below $5	52,000	—$212	0.4
$5 to $10	539,000	—39	.7
$10 to $15	573,000	—82	1.6
$15 to $20	687,000	—136	3.2
$20 to $30	990,000	—204	6.8
$30 to $50	873,000	—454	13.2
$50 to $100	435,000	—1,625	23.9
$100 to $200	124,000	—3,863	15.1
$200 and above	41,000	—29,040	35.1
Totals	4,314,000	—727	100.0

Revenue estimate (in billions of dollars)

1979	$3.20
1980	3.52
1981	3.86

During mark-up of the tax bill, I offered a substitute for the committee proposal. The amendment would allow individuals to exclude from gross income the first $500 of net capital gains ($1,000 in the case of a joint return). The 25 percent alternative tax on the first $50,000 of a noncorporate taxpayer's net long-term capital gain, the present add-on minimum tax and the tax preference offset to the maximum tax would be repealed. The present 50 percent exclusion from gross income for long-term capital gain would be increased to 60 percent.

As a result of these changes, a noncorporate taxpayer would pay no tax on the first $500 of net capital gains ($1,000 in the case of a joint return) and the maximum capital gains tax rate applicable to gains in excess of this amount would be 28 percent, i.e., 40 percent of the highest individual tax rate of 70 percent.

Clearly, this proposal is much closer to the President's position that the maximum capital gains rate should be approximately 30 percent.

Given the limitations of the entire tax package, it would appear more appropriate to accept this proposal and save some $600 million.

Corporate tax relief

The business tax reductions in the committee bill include an increase in the amount of tax liability that may be offset by the investment

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tax credit, an increase in depreciation deductions, and corporate rate cuts.

On the business side, the bill suffers from serious deficiencies in distributing a disproportionate share of benefits to larger businesses at the expense of the small business community which accounts for 97 percent of the 14 million enterprises in this country.

Investment tax credit

Under present law, a taxpayer receives a 10 percent tax credit for investment in certain business assets. This investment tax credit (ITC) may be applied against the first $25,000 of tax liability plus 50 percent of the tax liability in excess of this amount. Currently, the ITC accounts for a revenue loss of over $13 billion per year.

The committee bill would increase the present 50 percent tax liability limitation to 90 percent, to be phased in over four year period at the rate of 10 percent per year. The joint committee estimates this proposal would cost an additional $1.2 billion when fully effective in 1981.

Experts believe the ITC is a necessary incentive for capital formation and I agree. Increasing capital formation was a prime objective of the tax reform package originally drafted by the administration. However, the fact is that the largest corporations in the country receive virtually all of the benefits of the ITC. Indeed, corporations with over $10 million in assets account for 85 percent of the total credit, as reflected in the following table:

Distribution of Investment Tax Credit

Asset size:	*Percent of investment tax credit*
$1 to $25,000	0.4
$25,000 to $50,000	.2
$50,000 to $100,000	.5
$100,000 to $250,000	1.7
$250,000 to $500,000	2.0
$500,000 to $1,000,000	2.3
$1,000,000 to $2,500,000	3.2
$2,500,000 to $10,000,000	4.6
$10,000,000 to $25,000,000	2.8
$25,000,000 to $100,000,000	5.6
Over $100 million	76.7
Total	100.0

Source: 1974 corporate tax returns, Joint Committee on Taxation.

Depreciation

Studies have shown that smaller businesses which possess depreciable assets lag far behind in using the special capital recovery provisions of the law. A good example is the asset depreciation range (ADR) provision which allows a 20 percent shortening or lengthening of the "useful life" of equipment or machinery. The committee bill would in-

crease the ADR range from 20 to 30 percent at an additional cost over present law or some $3 billion by 1983.

Capital intensive businesses such as manufacturing firms and utilities are most likely to take advantage of ADR. However, according to a 1974 Treasury study, only 0.7 percent of all corporations or 11,042 corporations out of a total 1.6 million corporations surveyed elected ADR. Only one-half of 1 percent of all corporations with less than $5 million in total assets elected ADR. Over 90 percent of all corporations with total assets of more than $1 billion elected ADR. Clearly, ADR is used primarily by only the largest corporations and the committee bill would continue this concept without providing any relief for 99 percent of the Nation's corporations. The following table illustrates this point:

NUMBER OF CORPORATIONS IN POPULATION, NUMBER OF CORPORATIONS ELECTING ADR AND PERCENTAGE ELECTING ADR BY SIZE AND TOTAL ASSETS

Size of total assets	Total number of firms in population	Firms electing ADR	
		Number	Percent
$1 to $500,000	1,493,000	5,482	1.0
$500,000 to $1,000,000	56,000	1,064	2.0
$1,000,000 to $5,000,000	42,000	1,788	5.0
$5,000,000 to $10,000,000	5,000	665	13.0
$10,000,000 to $50,000,000	4,000	991	28.0
$50,000,000 to $100,000,000	625	304	49.0
$100,000,000 to $200,004,444	396	242	61.0
$200,000,000 to $300,000,000	156	107	69.0
$300,000,000 to $600,000,004	203	167	82.0
$600,000,000 to $1,000,000,000	88	80	91.0
Over $1,000,000,000	166	152	94.0
Total	1,601,634	11,042	0.7

Note: Only 0.7 percent of all corporations or 11,042 corporations out of 1,601,634 corporations surveyed elected to use ADR. Moreover, only one-half of 1 percent of all corporations with less than $5,000,000 in total assets elected ADR.

Source: 1974 Statistics of Income, Department of Treasury.

Since big business already receives over 90 percent of the nearly $3 billion appropriated for ADR and over 90 percent of the $13 billion of ITC, small business should be afforded a simplified method of capital recovery which would provide a greater after tax rate of return on investment to facilitate capital formation.

During markup, I offered an accelerated depreciation amendment to make available a massive simplification of depreciation for the 97 percent of the 14 million U.S. enterprises which are defined as small business.

While aimed at simplifying depreciation for small business, this amendment would permit any business to recover more rapidly the capital which it has invested in machinery and equipment by using

3 year straightline depreciation on the first $25,000 of assets purchased each year. Above that level, depreciation would be computed under the present system.

Although this proposal is limited to the first $25,000 of annual investment, the joint committee estimates that over 80 percent of all business enterprises purchase less than $25,000 in machinery and equipment each year. The joint committee estimates this proposal would cost $473 million in 1979.

The committee failed to adopt special depreciation provisions for small business contained in the House bill which would have increased the maximum deduction for additional first year depreciation from the present $2,000 to $5,000. In so doing the committee bill is totally devoid of any improvement in depreciation methods for small business.

Corporate graduated rate reduction

One major provision of significance to small business in the Finance bill is the concept of corporate rate graduation. Small business associations as well as the small business community at large have advocated this concept for many years. The committee adopted the House version of the corporate graduated rate reduction. However, this provision does not provide enough of the necessary tax relief small business desperately needs to continue to make significant technological and innovative contributions to our Nation's economy. In order to achieve a proper balance on the business side of the tax cut, small business ought to be given the benefit of 3 year straightline depreciation.

The committee's bill essentially provides most of the tax relief to the largest firms with taxable income in excess of $100,000. In fact, these firms which represent only 10 percent of all corporations would receive approximately $4.3 of the total $5.1 billion or 85 percent of the total corporate tax relief. In the event the top rate was reduced from 46 percent to 44 percent, big business' share would be increased to 91 percent. To best serve the needs of small business, thereby serving the needs of the Nation's economy, small business should receive its fair share of the overall corporate rate reduction. Under the committee bill, the corporate rate for firms with taxable income of less than $25,000 would be reduced from the current 20 percent to 17 percent. Since 69 percent of all corporations have taxable income of less than $25,000, the rate at this income level should be reduced to 15 percent to have a meaningful economic effect.

Conclusion

The 13 million enterprises in the Nation which are considered small businesses are entitled to a larger share of the bill's corporate tax reductions. These businesses account for 55 percent of the jobs in the private labor force—59 percent if farming is included—48 percent of the business output, and 43 percent of the gross national product.

There are meritorious provisions in the committee bill such as the concept of graduated corporate tax rates and substantial tax cuts for low and middle income taxpayers. However, as a matter of practical fairness the committee bill falls short of providing sufficient corporate tax relief to small and medium-sized firms.

Since these firms are the lifeblood of our economy the bill should be modified in accordance with the suggestions contained here when the bill reaches the Senate floor.

X. SUPPLEMENTAL VIEWS OF HON. WILLIAM D. HATHAWAY

I voted to report the Revenue Act of 1978 because I believe the taxpayers of this country need a reduction in income tax burdens in light of the recent inflation and Social Security tax increases. However, I believe that there are a number of revisions which should be made to HR 13511. A number of these specific provisions are reflected in legislation which I have previously introduced.

The Revenue Act of 1978 should meet the following goals:

A revenue effect reflecting the Congressional Budget Resolutions

An equitable distribution of individual tax reductions through all income levels

Nondiscrimination in tax treatment between small and large businesses

Significant items of tax reform

Simplification of the tax laws.

The Second Concurrent Budget Resolution for Fiscal Year 1979, adopted by the Congress, recommends total tax reductions for the fiscal year of $21.9 billion. Both the Administration and the Congressional Budget Committees have recommended against deep tax reduction in later years through enactment of provisions in the Revenue Act of 1978. The bill reported by the Senate Finance Committee reduces Federal tax revenues by an estimated $20.5 billion in fiscal year 1979. A revenue reduction of approximately $42 billion is expected for fiscal year 1980 and this amount increases to $66 billion by 1983.

The bill, as reported by the Senate Finance Committee, provides for a more equitable distribution of the individual rate cuts than the House-passed version. I endorse this approach, particularly in the expansion of the earned income tax credit and the adoption of advance withholding to reflect the benefits of the credit in the employees' weekly paychecks.

However, I believe the reductions in tax levels need to be further modified toward the lower to middle income taxpayer. The earned income credit changes are of some benefits, but, for example, a married couple with two children earning less than $20,000 per year, does less well under this bill than under legislation which I have consistently supported. When the effects of the capital gains reductions and modifications to the maximum tax on earned income are considered, the disparity in favor of high income taxpayers is even more pronounced.

The bill as reported by the committee would provide that 37 percent of the benefits would go to those taxpayers earning less than $20,000 a year; I believe this should be larger for those with less than $20,000 in income. Individuals with income over $50,000 would receive 23 percent of the benefits of the committee bill.

The changes in capital gains taxation and the adoption of the alternative minimum tax in lieu of the present add-on minimum tax are

estimated to reduce taxes for over 4 million taxpayers. For taxpayers with income over $200,000, the average capital gains tax cut would be almost $30,000.

The bill contains an excellent provision to assist the nation's senior citizens by increasing the tax credit for the elderly. However, I believe the bill is deficient in the area of property tax relief, probably the most burdensome of taxes imposed on the middle-income taxpayer. Failure to convert a portion of these taxes from a deduction to a tax credit penalizes many of the nation's taxpayers who do not itemize their expenses.

The Senate Finance Committee version of the Revenue Act is, I believe, even more tilted in favor of large corporations than the House-passed version. The Committee adopted the House graduated corporate tax rate schedule which lowers the rates to 17 percent on the first $25,000 of income and then graduates up to a maximum rate of 46 percent on all income over $100,000. Furthermore, the corporate capital gains alternative tax rate is reduced from 30 percent to 28 percent.

When this rate structure is combined with changes in the investment tax credit, the jobs tax credit and the expanded asset depreciation range system which the Committee adopted instead of the small business additional depreciation in the House-passed bill, the benefits available to smaller businesses are insignificant in comparison with the benefits for large corporations.

Tax reforms were recommended by President Carter when he submitted the 1978 tax proposals. Very few of these recommendations were included in the House-passed bill. However, even these modest proposals were deleted from the Finance Committee version. Only one provision concerning business entertainment expenses is included. In addition, the bill includes a deferral of the effective date of the estate carryover basis rules which were adopted in the Tax Reform Act of 1976. The significance of this issue and its brief mention in the Committee report compels further discussion.

The tax law prior to 1976 provided that the cost or other basis of property acquired from a decedent generally was "stepped up" to its fair market value at the date of death. This meant that appreciation in assets were not fully taxed on their subsequent sale.

The Congress believed this result was inequitable and therefore enacted the "carryover basis" rules as a part of the Tax Reform Act of 1976. The change provided that the basis of most property acquired from a decedent is to be the same as the decedent's basis immediately before his death (with certain adjustments). The basis of appreciated property is increased by Federal and state death taxes attributable to the appreciation in that property. In addition, the aggregate basis of all carryover basis property may be increased to a minimum of $60,000. A $10,000 exemption is provided for household and personal effects of the decedent.

In addition, as a transitional rule, the adjusted basis of property which the decedent is treated as having held on December 31, 1976, is increased to its fair market value on December 31, 1976. In essence, this rule continues pre-1976 law with respect to appreciation in property occurring before January 1, 1977, and provides everyone with a "fresh

start" with respect to the carryover basis rule for property acquired from a decedent.

The change made in 1976 is an essential element of a fair and progressive tax system. However, there are some technical modification which need to be made to the carryover basis rules. I support a bill to "clean up" carryover basis which contains the following major provisions: an increase in the minimum basis, a simplification of the death tax adjustment, an increase in the household effects exclusion, inclusion of a discount back formula to determine the "fresh start" adjustment, and an exemption of small estates from the reporting requirements.

I believe it is irresponsible to delay the carryover basis rules without making the necessary technical revisions.

It is imperative that the tax laws be simple and understandable. A Roper Poll released in July, 1978, reflected public attitudes toward the Federal income tax system. The public perceives the tax system as inherently unfair. They place a high priority on tax reform as making the system fairer. A comprehensive, simple and equitable law is required.

This bill with nearly 80 separate provisions, many of narrow scope, goes in the opposite direction.

The national economy and the taxpayers of this country need a responsible tax reduction enacted this year. The American people need a bill which makes the tax laws fairer, simplier and more equitable. This bill makes some progress in that direction, but much more remains to be done. I hope that the Senate will adopt changes to this legislation which will implement the goals I set forth at the beginning of these views.

XI. ADDITIONAL VIEWS OF HON. SPARK M. MATSUNAGA

Despite its shortcomings the committee bill does provide urgently needed individual and business tax reductions to boost our lagging economy. The basic provisions answer the economic objectives which I believe are foremost at this time.

On July 19, 1978, I joined Senator Lloyd Bentsen in introducing S. 3321, to provide a comprehensive tax reduction program. The Bentsen-Matsunaga bill anticipated most of the provisions reported by the House Ways and Means Committee in H.R. 13511 on August 4, 1978, and later adopted by the House on August 10, 1978. Our purpose in introducing the Bentsen-Matsunaga bill was to delineate a tax program which would meet our economic needs, obtain wide support, and at the same time come within the budget restrictions established by the joint congressional resolutions.

In voting to report the committee bill, I was guided by the following considerations:

First, the tax reduction to be enacted by this Congress must be a responsible tax cut. Although the administration hopes for an 8-percent rate of inflation for this year, consumer prices in June were reported to have risen by 0.9 percent which is an annual rate of about 11 percent. Even worse, the Commerce Department's index for urban consumers which covers nearly 80 percent of the population, rose at an annual rate of 11.4 percent for the quarter ending in June. This was up from the 9.3 percent annual rate in the first quarter and 4.7 percent rate in the last half of 1977. Clearly, the rate of inflation is accelerating at a rapid pace. An irresponsible tax reduction would only stimulate double digit inflation more.

Second, the tax cut must be directed at stimulating business investment. It is important to realize that in the long run, workers' real earnings can only increase with greater productivity. Yet, we have not made the business investments necessary to utilize modern technology and to increase our productivity. Capital spending in the United States has been inadequate. Capacity growth in manufacturing has declined from a gross rate of about 4.5 percent during the period from 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the third quarter of 1977 was 5 percent below its 1974 peak. Already, German and Japanese industries enjoy greater productivity than our own. It is therefore essential that this tax bill encourage new business investments for modernization and greater productivity.

Third, it is also crucial that a tax cut reduce the tax on long-term capital gains. A significant cause of the recent sluggishness in business investment has been the low after-tax rate of return on investment. There has been a downward trend in the rate of return on reproducible assets since the mid-1960's. The trend must be reversed. To encourage capital formation and especially investment in new, risky ventures, the capital gains tax rate must be cut.

Fourth, individual taxpayers must receive tax relief from increased social security taxes and inflation. Inflation and our progressive Federal income tax rate have sapped taxpayers' purchasing power. Although salaries have generally increased to meet inflation, our taxpayers have found their after-tax salaries inadequate to meet rapidly growing costs. Continued inflation would undermine our taxpayers' ability to provide their families with the basic essentials. Consequently, a tax cut must also be directed at individuals to relieve them of the oppressive burdens imposed by inflation and new social security tax increases. Individual taxpayers must be provided relief along with the business sector, for increased production without improved consumer ability to purchase would defeat its own purposes.

Lastly, the tax reduction must stimulate our stagnating economy. Although the jobless rate has dipped to 5.9 percent during the year's second quarter, the growth of the civilian labor force has remained on a plateau for the past 3 months. When the labor force increases in the coming months, our jobless rate will again soar. Yet, total employment in the last month grew only 156,000, far less than the 368,000 average monthly increase of jobs in the first half. In other words, our economy produced far fewer jobs each month this summer than it did during the year's first half.

These figures indicate a slowdown in our economic growth that may last for the rest of the year. The growth in retail sales has also lagged, rising only 0.2 percent in July, 0.1 percent in June, and 0.2 percent in May. New factory orders plunged 3.8 percent in July, the largest monthly drop in nearly four years. The administration now projects an economic growth of between 3.5 percent to 4 percent. However, some private economists are projecting a growth rate of 3 percent or less for the remainder of the year. A responsible tax cut is needed at this time to stimulate our economy and prevent us from falling into the same economic slump that has beset certain European countries.

I have not been wedded to the particular provisions contained in the Bentsen-Matsunaga bill. I have worked on the present bill with an open mind, considering alternatives and supporting substitute provisions. I believe the basic bill answers our economic needs. Although the total reduction may exceed our budgetary constraints, past experience would seem to support the theory that feedbacks into the economy which expand the tax base would make up for the seemingly excessive costs.

XII. ADDITIONAL VIEWS OF HON. ROBERT J. DOLE

The Revenue Act of 1978, as reported by the Senate Finance Committee, is a positive step towards easing the current tax burden on the American taxpayer. However, the bill does not adequately protect the taxpayer from future tax increases.

Taxflation

The No. 1 problem in our tax system is inflation. During periods of inflation, the net effect of our current system of taxation is to push low and middle income taxpayers into higher tax brackets without any corresponding increase in the real purchasing power. A taxpayer who earns $15,000 in 1978 will have to earn $16,200 in 1979 just to stay with our 8 percent inflation rate. However, his real tax liability will be increased $260. An individual, earning $30,000 will have to increase his income up to $32,400 just to stay even with inflation but his tax bill will rise by $850.

Tax equalization amendment (TEA)

During the committee markup on the Revenue Act of 1978, I introduced a proposal to make periodic inflation adjustments in our tax system. My proposal called for an inflation adjustment for 2 years, effective 1980, to the personal exemption, the tax brackets, and the zero bracket amount. Unfortunately, the proposal was narrowly defeated. Indexing the tax system to the rate of inflation would help neutralize the tax impact of inflation by maintaining the effective rate of taxation for any given income level at the rate originally legislated.

There is no tax reform that is more important to the American taxpayer than indexing. The concept is not new. Other nations that are burdened with inflation have been looking for a way to eliminate the effects of inflation on their tax system. Several—Canada, France, West Germany, Brazil and Denmark—have succeeded in indexing their tax system in a way that is instructive for the United States. Since 1974, for example, Canada has been indexing its personal income tax by adjusting individual tax brackets, credits, and deductions to take account of changes in the cost of living. In the past year, the states of Arizona and Colorado have extended indexing to their state tax systems. California has also enacted a modified version of indexing.

Repeal automatic tax increase

The need for indexation has been underlined by Congressional action in enacting yearly tax reductions for the past three years. Congress has tried to keep taxflation under control by periodically cutting taxes. When the economy becomes too distorted by tax inflation, Congress rescues the taxpayer by modestly reducing his taxes. Congress gives itself credit for such enlightened action. However, the taxpayer is usually in no better condition than if tax inflation were eliminated. In effect, tax reduction by Congress is nothing more than repealing automatic tax increases caused by inflation.

It has been said that indexing the tax system would be the acceptance of inflation. I totally reject that type of logic. The fact is, the Federal Government is the benefactor of tax inflation. Each year the

government receives billions of dollars in new revenue as a result of inflation.

This vested interest would end if we could deny this "windfall bonus". Tax indexing is an idea whose time has come. The Tax Equalization Amendment provides fair and equitable treatment for all taxpayers.

Capital gains adjustment

Unfortunately, the Committee chose not to include a provision in the House bill which would have initiated an indexing system to prevent excessive taxation on capital gains. The current tax system, in effect, taxes inflationary appreciation on capital assets. For example, if an asset is purchased in 1980 for $30,000 and sold in 1983 for $50,000 the tax system would consider the gain to be $20,000. If the inflation rate during that date of purchase and sale is 20 percent, the taxable gain reflects appreciated value due to inflation. If we remove the inflation factor, the taxable gain would be on $14,000—the real gain—since $6,000 of the $20,000 is not real gain, but only a nominal increase due to inflation. The asset indexing feature in the House bill is the most significant portion of that piece of legislation. It should have been retained by the Finance Committee.

Productivity tax credit

The Committee refused to deal with the effects of inflation on our tax system and in doing so made the conscious decision to tax inflation. However, I believe that the tax system can be used not only to minimize the effects of inflation but also to reduce inflation.

One of the reasons for the current wave of inflation is the decline in American productivity. In recent years, the federal government has created disincentives—through government regulation, too much red tape, and oppressive tax rules—for increasing American productivity. The productivity of the American work force, measured over the last 10 years, has been less than a quarter of that of Japan. Even the troubled economy of Great Britain has greater productivity than does the United States.

A *productivity tax credit* which goes *directly* to the worker, based on his wages, if the worker is employed by a company that does *not* raise its prices over a modest level from the preceding year, should be considered.

Congress has made permanent the investment tax credit for machinery. A number of other tax incentives have been considered to stimulate the American economy. As a matter of national policy, Congress has decided that tax credits for machines are in the national interest. Yet assistance is denied to our most valuable resource—the American working man and woman. I believe Congress should consider a productivity tax credit.

The Productivity Tax Credit would provide *both* the employee and the employer incentives to increase productivity and hold the line on price increases. The tax system is used to encourage capital expenditures, to promote home ownership, to encourage energy exploration and conservation. Why not use it to control inflation? The Committee has asked the Treasury Department to examine my proposal and report its recommendations next year.

Pension plans

The Finance Committee also adopted a provision which is a step to preserve the integrity of qualified pension plans. Under the current law, neither mandatory nor voluntary employee contributions to qualified pension plans are tax deductible, and qualified plan participants cannot establish individual retirement accounts. However, current law provides a tax deduction for contributions to an individual retirement account. In recent years, many employees have been electing out of their employers' qualified plans in order to establish an IRA. If a number of the employees leave the existing plan, there is a danger that the plan will be disqualified, because it can no longer meet the non-discrimination requirements imposed by the law. The trend of plan terminations is gradually eroding our private pension system.

In order to combat this result, the Committee adopted a provision which would allow an employee participant in a qualified plan a limited education for their contributions to the plan. Voluntary contributions would be limited to 10 percent of income or $1,000 a year, whichever is less. Mandatory contributions under the Committee bill would be the lesser of 10 percent or $100.

Personal exemption for the disabled

The Committee bill also contains an amendment to grant an additional personal exemption to those who are severely disabled. Because the handicapped have certain financial costs that are not experienced by other taxpayers, providing them an extra personal exemption is good policy and should be retained in the final version of the bill.

For over thirty years, the blind have been permitted to claim this additional exemption. I feel this is justified, but current law is restrictive. Individuals with other handicaps also have extraordinary expenses related to their condition. In the Committee's efforts to promote fair treatment under our tax code, the decision to expand coverage to include all disabilities was proper.

The disability exemption will provide a $500 exemption in 1979 and 1980, expanding to $1,000 in 1981. The exemption is available only to the disabled taxpayer and/or his disabled spouse, and to persons not receiving cash benefits under government programs. This would prevent disabled veterans, disabled civil service employees, and SSI recipients who receive government payments, from claiming the additional exemption. The amendment offers relief primarily to the disabled person who fits into the category of the "working poor". Those persons who rely on government assistance are ineligible.

Public support

In a recent study, a public opinion research organization found that public opinion strongly supported an increased personal exemption for the disabled. According to the study, 84% of the persons questioned were in favor of this revision. I am pleased that the Committee voted to allow disabled persons this additional exemption, and urge that it become law.

Carryover basis

The Committee acted to defer the "carryover basis provisions" until 1980. Carryover basis was enacted in the Tax Reform Act of 1976 without ever being considered by the Senate. The carryover basis rules are a nightmare. They are essentially unworkable. The implementation of the carryover basis rules should be delayed until Congress can

carefully study this issue. The Congress should not adopt a quick fix-up without careful consideration.

Conclusion

Finally, there are some provisions in this bill which I do not support. Particularly, I am concerned that the Committee agreed to raise the maximum amount of the earned income credit to $600 from $400 and to extend eligibility to $11,000 of income.

The American taxpayer needs and deserves a tax break. The American economy needs tax reduction and new capital for business expansion. The Finance Committee, to a limited extent, accomplished these goals.

Provisions related to Social Security Act Programs

Section 601 of the bill provides for a one-time fiscal relief payment to the States designed to help meet State and local welfare costs. The payment would be based on improvement in State welfare error rates through March 1979. Since the formula used would be based on quality control reports made under existing regulations, the provision would also have no significant regulatory impact.

Section 602 of the bill modifies the title XX social services program primarily by providing an increased level of Federal funding. Also included in this section, however, are amendments to the State planning requirements which should give States added flexibility and thus lessen somewhat the regulatory impact of the program.

Sections 603–606 of the bill contain a number of amendments designed to improve the operations of the aid to families with dependent children (AFDC) program and the related child support program. The AFDC program is a State-operated assistance program which receives Federal matching funds through title IV of the Social Security Act. As of March 1978, 10.9 million individuals were recipients of benefits under this program. The regulatory impact of the provisions in these sections of the bill are largely confined to these individuals and the State and local welfare agencies which administer the program and their employees. In general these sections provide additional Federal support to the States in the attempt to strengthen the administration of these programs. The regulatory impact would be minimal and would be largely confined to the necessary assurances that the added Federal aid was properly utilized.

Sections 607 and 608 increase Federal funding for public assistance programs in Guam, the Virgin Islands, and Puerto Rico. Apart from regulations implementing the increased funding, no regulatory impact should result from these provisions. Section 609 extends to the Northern Marianas the welfare programs now applicable to the other territories. This would require HEW regulations to become applicable to that jurisdiction in the same manner as they are applicable to the other territories.

B. Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 5263, as amended by the committee, was ordered favorably reported by the following rollcall vote: In favor (15) : Messrs. Long, Talmadge, Ribicoff, Byrd (Va.), Gravel, Bentsen, Hathaway, Matsunaga, Moynihan, Curtis, Hansen, Dole, Packwood, Laxalt, and Danforth; Opposed (3): Nelson, Haskell and Roth.

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