Issues In Federal Tax Revision

1. Tax Developments In 1973

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The drive for Federal tax revision, more popularly referred to as tax "reform," which gained prominence during the 1972 political debates, got actively under way early in 1973. Extensive hearings were held before the Committee on Ways and Means on a lengthy agenda of tax topics. For various reasons the initial time table for Congressional action on taxes was delayed and will be carried over into 1974, when a major tax revision measure is expected to emerge. This report, the first in a series, provides background on the issues in tax revision. It summarizes the testimony presented in Congress, the Administration's tax proposals, and other developments in 1973 which seem likely to influence the outlook for tax revision.

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TAX DEVELOPMENTS IN 1973

In recent years the topic of Federal tax reform has become a perennial contender for public attention. The Tax Reform Act of 1969, approved after almost a full year of Congressional consideration, introduced extensive revisions in the Federal tax system. Further significant changes were enacted in the Revenue Act of 1971. Early in 1972, a presidential election year, tax reform emerged as the leading economic issue in public debates, and hundreds of bills were introduced in Congress calling for "tax reform," generally aimed at imposing higher tax burdens on wealthy individuals and large businesses. While these bills did not result in formal consideration by Congress in 1972, the political commitments made then promised to sustain the momentum for further change in the months ahead.

Developments in 1973 indicate that Federal tax revision remains quite a live issue. The opening days of Congress saw the introduction of a flood of proposals. Major attention, however, was focussed on hearings before the House Committee on Ways and Means, following an approach similar to that suggested in 1972 by the Committee's chairman, Wilbur D. Mills.

The Committee conducted extensive panel discussions and public hearings on the subject of tax reform during the period from February 5 through April 19. Following the hearings, and after the Easter recess, the Committee heard the Administration's proposals for tax reform, as presented by Treasury Secretary George P. Shultz, on April 30.

Time Table for Tax Revision

Early in 1973 Mr. Mills expressed hope that the Committee would complete a tax bill by mid-June, with passage by the House in the summer. However, after the hearings, the markup of a tax bill was put aside pending consideration of the Administration's foreign trade proposals (completed as far as the Committee was concerned on October 10); raising the temporary debt ceiling; private pension system reform; and Social Security legislation.

In acting on the debt ceiling, the Committee on Ways and Means (October 25), and later the full House, were able to circumvent moves to tack onto the debt bill a "mini-tax reform" measure and increases in Social Security benefits. Congressman Al Ullman, acting chairman of the panel during the recent illness of Mr. Mills, did, however, pledge Committee consideration of these two matters separately in early November; he instructed the staff of the Joint Committee on Internal Revenue Taxation to prepare proposals that would raise some $1.5 billion in new revenues annually.

On November 9 the Committee approved a bill increasing Social Security benefits by 11 percent by July 1974, and raising the payroll tax base. (Congressional approval of a similar Social Security measure before the end of the year seemed assured.)

Following the Social Security decisions, the Committee on Ways and Means once more turned to private pension system reform. In addition, it began consideration of possible tax changes, concentrating on tightening up the minimum tax on "preference" income. (Press reports in mid-November indicated that Mr. Mills had ruled out action on any substantive tax revision in 1973, and that he expected to return in January to lead the Committee in writing a major tax bill.)

Thus the original schedule for major tax revision has been extended well into 1974. Even without these delays, many observers have felt all along that the comprehensive agenda set up for the tax reform hearings would mean that new tax legislation in the 93rd Congress would be a two-year job. This schedule would conform to the usual pattern of tax revision over the past decade. The Revenue Act of 1962 was two years in the making, as was the Revenue Act of 1964. The Tax Reform Act of 1969, an exception to the pattern, was completed in a single year.

Scope of Tax Revision Proposals

After the hearings on tax revision before the Committee on Ways and Means, additional new and controversial suggestions for tax revision were advanced by Mr. Mills and by the Administration. Still other recommendations may yet emerge. Nevertheless, the comprehensive agenda for tax revision set up by the Committee on Ways and Means for its hearings in early 1973, together with the Administration's formal tax proposals, suggest major areas where changes may be made.

This report summarizes the panel discussions and testimony from general public witnesses before the Committee, and the Administration's proposals; and reviews subsequent developments affecting the outlook for tax revision in 1974.

PANEL DISCUSSIONS

In the period from February 5 through February 28, some 56 panelists, especially invited by the Ways and Means Committee, presented testimony on an enumerated list of specified subjects. The topics covered eleven generally broad-ranging areas, as follows:

1. Objectives and approaches to tax reform and simplification
2. Capital gains and losses
3. Tax treatment of capital recovery (investment credit, accelerated depreciation, and amortization)
4. Tax treatment of real estate
5. Farm operations
6. Minimum tax and tax shelter devices
7. Pensions, profit-sharing, and deferred compensation
8. An alternative to tax-exempt state and local bonds
9. Natural resources
10. Estate and gift taxation
11. Taxation of foreign income

The panelists, all experts in the subject areas they were invited to discuss, were chosen so as to represent opposing points of view on each topic. The opinions expressed were thus sharply divided on almost all issues. Among the relatively few points of agreement were these: (1) there is need for simplification of the Federal income tax, and certain provisions in particular lend themselves to such revision; (2) issuance of taxable state-local bonds, with a Federal subsidy, is agreeable as an optional alternative for states and localities; and (3) the 50-percent top marginal rate on earned income should be extended to income from all sources. (There were differences of opinion, however, as to the base to which the rate limitation would be applied.) As one panelist put it, the 50-percent maximum tax has important symbolic value–it gives the taxpayer "an even break." (4) Even though opinions among panelists clashed sharply on most aspects of capital gains taxation, there was wide, but not unanimous agreement that an inflation adjustment should be made in determining the amount of gains subject to tax, and that there should be a liberalization of present limits on loss carryforwards and carrybacks against other income, consistent with the treatment of gains.

Conflicting views were presented not only on specific provisions of the tax law, but even on the major goals to be sought in tax revision. While redistribution of income is often viewed as a major objective of tax policy, one panelist questioned this view, holding that tax theorists have no special expertise on the subject of social policy in the redistribution of income, and "no right to try to impose their personal preferences on others by embodying them in the principles of taxation." Views differed also as to the appropriateness of the present rate of progressivity of the Federal income tax. Some panelists presented caustic criticism of provisions of the law permitting preferential treatment of some kinds of income, which they referred to as "loopholes." At the other end of the spectrum was the view that many of the principal so-called loopholes are considered such only because they are "evaluated against a standard calling for punitive taxation of saving as compared with consumption."

GENERAL PUBLIC WITNESSES

Although the panel discussions were limited to certain specific areas of tax revision, the Committee on Ways and Means announced that the second phase of its work–general public hearings–would encompass all areas of the Internal Revenue Code, with concentration in 20 broad areas. In each case the agenda noted that the scope of topic included, but was not limited to, the specific items listed. The list was as follows:

1. Estate and gift tax revision
2. Treatment of capital recovery for tax purposes
3. Taxation of capital gains and losses
4. Tax treatment of real estate
5. Natural resources
6. Farm operations
7. Personal property leasing
8. Treatment of interest deductions
9. Tax treatment of limited partnerships
10. Minimum tax
11. Tax treatment of employee stock options
12. An election to issue taxable bonds
13. Taxation of foreign income
14. Pension and profit sharing plans and other deferred compensation
15. Tax treatment of political contributions
16. Corporate tax provisions not included specifically elsewhere
17. Special industry tax problems
18. Tax treatment of other items especially affecting individuals
19. Tax treatment of foundations and charitable contributions
20. Tax simplification

A diverse group of some 300 witnesses testified before the Committee in this second phase of hearings, which began on March 5. Included were representatives of business and industry, labor unions, local governments, professional associations, foundations, and others. The hearings were concluded on April 19, with testimony from members of Congress in the final three days.

Testimony of Business

While the topics covered were wide-ranging, greatest emphasis in testimony presented by business representatives was on tax treatment of capital recovery, foreign source income, depletion allowances, and capital gains and losses.

Industry groups expressed grave concern regarding proposals to impose heavier taxes on business, and generally stressed the need for removing some of the existing "anti-business" bias in the tax laws. Especially criticized were proposals to eliminate or change the investment tax credit and the accelerated depreciation system. Witnesses supported these instruments on grounds that they improve our economic health, enhance productivity, create jobs, and enable the United States to become more competitive in world markets. In view of inflation, and its constant erosion of the replacement value of cost recovery allowances, many spokesmen urged liberalization of present depreciation allowances for tax purposes. There was also wide agreement among witnesses that there is need for improving cost recovery allowances for antipollution control facilities; existing provisions were termed by one witness as "little more than a poor joke."

In the face of proposals for further tightening of depletion allowances, industry representatives urged that Congress consider restoring the depletion allowances in effect before the Tax Reform Act of 1969, instead of applying new restrictions. Witnesses based their arguments on the overriding need for assured sources of energy supplies and the associated capital needs for further exploration and development efforts.

The need for a full foreign tax credit and the present treatment of undistributed earnings of foreign subsidiaries was stressed by public witnesses. The proposal to repeal the credit (and allow only a deduction from income for taxes paid abroad) would, it was noted, penalize foreign income by subjecting it to a tax rate much higher than that on other kinds of income, thus reducing the rate of return on foreign investments to the point where such investments would no longer be desirable.

Various aspects of capital gains taxation were discussed by industry witnesses who opposed proposals to increase taxes on capital gains, and thus impose additional burdens on venture capital to encourage new enterprise. Some urged repeal of the 1969 provisions which raised the capital gains tax rates by over 20 percent. Others urged full consideration of a measure introduced by Representative Joel T. Broyhill, providing for a new system of capital transfer taxes, by which long-term capital gains of individuals would be taken out of the income tax system and, in alignment with estate and gift taxes, would be taxed as transfers of capital.

Among other proposals by industry groups were those for revisions in the minimum tax (on "preference income") as it affects business, simplification of present provisions concerning employee moving expenses, modifying present double taxation of corporate income, raising the $25,000 surtax exemption under the corporate income tax, and repeal of the penalty tax on intercorporate dividends.

Testimony by Members of Congress

More than a dozen members of Congress testified before the Committee. Some witnesses presented proposals for changes in single provisions of the tax code, such as additional tax relief for home improvements, single taxpayers, renters, blood donations, artists, etc. Three of those testifying, however – Senators McGovern, Kennedy, and Muskie – urged broadscale "tax reform" packages similar to measures introduced during the 1972 political debates. While details differed somewhat, there were many common elements. Senator Muskie noted that a bill he has introduced would attack "upper-income and corporate loopholes thoroughly and comprehensively," to raise some $18 billion annually in new revenue by 1975 and more later. Among provisions of his plan were: tightening the treatment of depreciation (to gain $5 billion more in revenues); allowing the investment tax credit only for net increases in investment; reducing percentage depletion allowances; restricting "preferential" treatment of foreign income and investment; and imposing heavier taxes on capital gains.

Senator McGovern presented proposals which, he said, would give $11.5 billion in additional revenue the first year, some of which he would apply to "reducing the tax on ordinary citizens and the rest should be invested in our needs at home." His proposals included: for large firms, repeal the Accelerated Depreciation Range system and limit the investment tax credit to net increases in investment; tax unrealized capital gains at death; substitute a tax credit in place of the personal exemption; remove the $100 dividend exclusion; withhold on interest and dividend payments; and repeal DISC and other "tax breaks" for foreign earned income. In addition he suggested imposing limits on the amount of income taxpayers with gross incomes above $25,000 can "shelter from taxation by exploiting existing loopholes."

Senator Kennedy, expressing his "full support to the growing commitment in Congress to tax reform," proposed 20 changes in tax laws, generally similar to those presented by Senators McGovern and Muskie. His plan, he said, would raise revenues of the order of $5-10 billion, and possibly $15 billion in the first year, and larger amounts in future years.

THE ADMINISTRATION'S TAX PROPOSALS

On April 30, Secretary of the Treasury Shultz presented the Administration's tax proposals. He prefaced his remarks by declaring that the present Federal tax structure is basically sound and has been improved by two major tax acts in 1969 and 1971. He told the Committee: "We can't expect to overhaul the entire tax system every two years." Major goals of the proposals, Mr. Shultz said, are the attainment of tax equity, simplification, and economic growth. He described the proposals as "essentially neutral in their budgetary effect."

The recommendations, presented in the form of a 175-page booklet entitled "Proposals for Tax Change," are diverse. Among them are recommendations for: tighter tax rules on so-called "tax-sheltered" income of wealthy individuals; simplification; new tax credits for property taxes paid by the elderly, for private school tuition, and for exploratory drilling; and Federal subsidies for taxable municipal bonds.

The text of the proposals also included the provisions concerning taxation of foreign income, which were contained in the President's April 10 message to Congress on trade legislation. The Ways and Means Committee concluded its hearings on trade matters June 15; it was subsequently decided that the associated tax measures would be considered as an integral part of the general tax revision bill which would emerge from the committee, rather than as part of a trade bill.

A. Taxation of Wealthy Individuals

The Administration proposed repealing the 10 percent minimum tax on individual preference income adopted in 1969, and substituting stronger measures aimed at "tax-shelters." The two facets of the plan are the Minimum Taxable Income (MTI), dealing with tax items that are presently outright exclusions from income; and a Limitation on Artificial Accounting Losses (LAL), dealing with tax rules that provide deferrals. These proposals would apply to individuals only; corporations would continue to be subject to the minimum tax.

The MTI and LAL provisions go much further than the 1969 act in limiting the use of a combination of "preferences" and deductions by wealthy taxpayers to reduce their tax. In combination, the measures would raise about $1 billion in revenues, for a net revenue gain of $800 million after taking into account the revenue loss of about $200 million from repeal of the present minimum tax on individuals.

1. Minimum Taxable Income. The MTI, according to Mr. Shultz, would prevent the combination of exclusions and itemized deductions from offsetting more than one-half of a taxpayer's income. In determining taxable income, the following presently excluded items would be added to adjusted gross income: (1) one-half of long-term capital gains; (2) the "bargain" element of certain stock options (i.e., the excess of fair market value over the option price); (3) percentage depletion in excess of adjusted basis; and (4) earned income from foreign sources. To the expanded gross income figure, the taxpayer could deduct extraordinary medical expenses and casualty losses, and a flat $10,000 exemption. The resulting amount is the minimum taxable income base, and it is divided by two to determine a taxpayer's Minimum Taxable Income. The taxpayer would be required to pay either the tax on normal taxable income, as computed under present law, or the tax on Minimum Taxable Income, whichever is greater, based on the regular schedule at rates ranging from 14 to 70 percent.

In general, the provision would not affect those with incomes below $50,000; above that figure, it would apply only to those who have large deductions and exclusions from income, an estimated 130,000 taxpayers.

2. Limitation on Artificial Accounting Losses (LAL). This provision is designed to eliminate "tax shelters," by disallowing the deduction of "artificial tax losses" in the current year that exceed the net related income for the year. Examples of deductions subject to the limitation include prepaid feed in livestock feeding syndications, intangible drilling expenses, taxes and interest during construction, and accelerated depreciation in excess of straight-line depreciation in the case of buildings. If these deductions create a loss from the activity to which they relate, that loss may not be used to offset other unrelated income of the taxpayer. The artificial "loss" could be carried forward to be deducted against net related income in a future taxable year. In general, the limitation would not apply to taxpayers who are "regularly and profitably" engaged in the business activity involved.

B. Simplification

The Administration proposed several steps toward what it termed the "long-range project" of simplifying the tax law, with suggested changes applicable to the average taxpayer. Included are provisions for changes in the treatment of certain deductions and exclusions from income: the creation of a new simplified tax form: and the use of a new tax table in computing tax due. Approval of all these measures would result in an estimated $400 million revenue loss. The simplification proposals have essentially four elements:

1. A new simplified Form 1040-S, to be used by most taxpayers who itemize deductions. Use of the form requires Congressional approval of a miscellaneous deduction allowance of $500 per return for every taxpayer who itemizes, together with the repeal of certain deductions and exclusions:
   a. Allow no itemized deductions for the first $200 of deductions now listed on the form as "miscellaneous deductions."
   b. Permit combined medical and casualty deductions only to the extent that the total exceeds 5 percent of adjusted gross income;
   c. Eliminate the dividends received exclusion;
   d. Eliminate the deduction for gasoline tax and other miscellaneous taxes
   e. Eliminate the sick pay exclusion.
2. Revise the child care allowance by providing a $4,800 annual limitation (but not more than the amount of earned income of the lesser compensated spouse), abolishing the present distinction between care inside and outside the home, and phasing out the deduction dollar-for-dollar for incomes in excess of $22,800.
3. Require all taxpayers with taxable income under $20,000 to use a new table based on taxable income rather than the present tables based on adjusted gross income.
4. Enact a new age credit to replace the complex retirement income credit. The present credit is said to be so complicated that "tens of thousands" of elderly taxpayers compute it incorrectly or fail to claim it; the new age credit would be slightly more liberal and "vastly more simple." (Revenue loss, $200 million.)

C. New Tax Credits

1. Property Tax Credit for the Elderly. The credit, on a refundable basis, would be available to low and middle income elderly homeowners to relieve the burden of "excessive" property taxes. The credit would be allowed for real property taxes in excess of 5 percent of household income, up to a limit on the credit of $500. Equivalent relief would be afforded to elderly renters. The credit would be phased out for incomes between $15,000 and $25,000. (Estimated revenue reduction, $500 million.)
2. Nonpublic School Tuition Credit. The credit, also on a refundable basis, would be available to parents of nonpublic elementary and secondary school pupils. It would apply to tuition paid to nonprofit schools, at the rate of 50 percent of the tuition paid for each child up to $200 in a single year per child. The credit would be phased out as income rises above $18,000. (Revenue reduction, $450 million annually, is already included in the Administration's fiscal 1974 budget.)
3. Exploratory Drilling Credit. Under this proposed credit, a driller of a new domestic exploratory hole could claim the 7 percent investment credit on intangible drilling costs plus an allowance for geological and geophysical expenses; if the exploratory hole proves commercially productive, a supplementary credit of 5 percent of the intangible drilling costs would be allowed against the first tax payable on net income from the

production. The 7 percent credit would be subject to the same overall limitations which now apply to the investment tax credit. The credit is designed to stimulate new exploration in the United States; it would offset the effects of limitations imposed under the Limitation on Artificial Accounting Losses, and to some extent under the Minimum Taxable Income. (Estimated revenue loss, $50 million annually.)

D. Taxable Municipal Bonds

State and local governments would have the option of issuing either tax-exempt bonds, as they do now, or bonds on which interest would be subject to Federal income tax. On qualifying taxable bonds the Federal government would pay an interest subsidy equal to 30 percent of the net interest expense. The Administration holds that this provision would increase the financing capabilities of state-local units because the higher-interest subsidized bonds would be on a better competitive basis in the market than tax-exempt issues. (First-year revenue costs of $180 million are estimated by the Treasury to be roughly offset by increased tax receipts on the subsidized bonds.)

The Administration also suggested technical revisions in regulations with respect to arbitrage on advance refunds of state and municipal securities.

E. Tax Return Preparers

The Administration's proposals are designed to encourage greater responsibility on the part of tax preparers for the returns they prepare and to raise the degree of compliance with the tax law. The approach suggested is: to require identification numbers of tax preparers on the return; to impose civil penalties for "negligent and intentional disregard of rules and regulations" and for "willfully understating tax"; and to make injunctions available against unscrupulous and incompetent preparers.

F. Taxation of Foreign Source Income

1. In countries which provide tax holidays from local taxes in order to attract investment, it is proposed to tax U.S. shareholders on the earnings from new investments which enjoy such tax incentives, even before such earnings are repatriated. Similarly, a U.S. – controlled corporation which moves its plant to enjoy lower foreign tax rates, while manufacturing goods for the U.S. market, would be taxed currently in the United States.
2. Where U.S. companies deduct losses from foreign branch operations against U.S. income, it is proposed that subsequent foreign tax credits be reduced by the amount of such losses.

OTHER DEVELOPMENTS AFFECTING FUTURE TAX REVISION

After the hearings before the Ways and Means Committee, several new developments occurred which may have an important influence on the outlook for tax revision in 1974.

In late August Mr. Mills suggested that some (as yet unspecified) type of new tax incentives be provided for some 15 to 20 industries that produce goods that are or may become scarce (in exchange for perhaps a 2 percentage point increase in the corporate income tax rate). The plan, according to Mr. Mills, looks "beyond inflation." He said that he was "trying to stop a depression" by ensuring that certain industries are not paralyzed by the Administration's "plans to slow down the economy." Mr. Mills has indicated that when the Committee resumes its work next January, it will immediately consider the new tax incentives he has proposed, and when action on them is completed, will turn to preparation of a major tax bill.

Just as there have been changes in the schedule and indicated direction of tax revision plans by the Committee on Ways and Means, there has also been some uncertainty as to the Administration's goals for tax changes. President Nixon has pledged not to increase taxes. In presenting the Administration's tax proposals on April 30 Secretary Shultz said that the Administration feels that a general tax increase is "both unnecessary and undesirable." In his second State of the Union message to Congress on September 10, the President said "this Administration continues its strong opposition to a tax increase."

Several statements by Administration officials in recent months, however, have raised question as to whether the White House's opposition to a tax increase may be softening. On July 10, Roy L. Ash, Director of the Office of Management and Budget, reportedly told a luncheon group that if spending goes much beyond the $268.9 billion spending target of the Administration, there is a feeling at the White House that "we should have some tax increases."

On September 13, Melvin R. Laird, Counselor to the President, discussed at a news conference two possible tax changes which he said were under consideration by the Administration. One was an across-the-board "refundable" tax surcharge, of perhaps 10 percent, on individual and corporate income, to be collected in an inflationary stage and refunded when the economy turned soft. The other change would convert the 7 percent investment tax credit to a variable basis ranging from perhaps 4 to 15 percent, with the lower rates applying during periods of boom and higher rates in slack times in the economy. Both of these ideas for tax change had previously been proposed by Arthur F. Burns, Chairman of the Federal Reserve Board.

One element of uncertainty in the outlook for tax revision is clearly the future course of Federal spending. Although original estimates of revenues have been revised upward, projected outlays are also higher for fiscal 1974 than the January budget estimates. By late October, 1973, Congress had increased the Administration's 1974 budget requests by $2.9 billion and further increases were in the "legislative pipeline," according to Congressman George H. Mahon of the House Appropriations Committee. Thus total 1974 expenditures will be higher–by a significant but undetermined margin–than the $268.9 billion ceiling originally recommended by the Administration and widely accepted by members of Congress.

Finally, one of the newest developments–the "energy crisis"–has already raised questions and controversy over the possibility of using tax measures to deal with emerging problems in the conservation of fuel.

Advocates of tax "reform" testifying at hearings early in 1973 generally placed emphasis on closing so-called "loopholes," with revenue-raising considerations apparently playing a secondary role. Similarly, the Administration's tax proposals were said to be neutral in their budgetary effects. The foregoing recent developments, as well as questions still pending in Congress (e.g., Social Security tax increases) suggest that the issues in tax revision in 1974 may well become more extensive and more complex than those originally anticipated when the agenda was drawn up early in 1973.

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