

TAX FOUNDATION

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SPECIAL REPORT

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TAX REDUCTION AND REFORM

A Summary of the President's Tax Proposals



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This is a brief summary of the main features of President Kennedy's sweeping tax proposals, as explained and amended by Sec. of the Treasury Dillon on February 6, 1963. No detailed analysis is attempted, but to provide a guide for the reader a few of the major issues raised by this tax plan are listed below.

1. Will the program "encourage business investment, increase job opportunities, improve productivity, step up economic growth" or is it designed primarily to put more money in consumers' pockets?

Most of the "tax relief" goes to taxpayers in lower income brackets. The aim is apparently to provide "shot-in-the-arm" stimulants to the economy. Is this the kind of overall reform of the tax structure that the economy needs?

2. Are taxes on business being reduced substantially to increase profit margins and leave more funds for investment and expansion purposes?

Apparently not for five years at least. Because of the speed-up in tax payments, receipts from corporations will increase in fiscal 1964 and 1965. In fiscal 1966 the reduction in total corporate payments will be about \$1 billion. It will be 1969 before the full five-point reduction in corporate rate is effective.

3. Is the proposed program a "substantial tax reduction?"

While the total cut in individual liabilities is \$8.7 billion, it will not be effective until calendar 1965. Most taxpayers who itemize deductions will get only small reductions in 1963. For some, taxes may rise. Reductions will be offset to some extent by the \$2 billion increase in social security taxes in 1963 (and again in 1966), and by a rise in state income taxes. (Nineteen states allow Federal taxes as a deduction, and other states use Federal taxable income as their base. In both cases, state income taxes will increase.)

4. Is this proposal true reform of the tax base?

The income brackets remain unchanged. Deductions for taxes, interest, charitable contributions etc., are also in general unchanged, but allowed only to the extent that they exceed 5% of income. The net effect is to apply a squeeze on deductions for revenue purposes.

5. Are the estimates of the revenue effects sound?

Much reliance is placed on increases in revenue due to growth in the economy as a result of these tax changes. Some proposed changes, such as the repeal of the dividend credit and exclusion, have only recently been rejected by Congress. The \$650 million increase in capital gains revenues is based on the speculative assumption that there will be a large increase in capital gains transactions as a result of the changes proposed.

6. Are tax cuts of the kind proposed risky in the face of current deficit levels in the Federal budget?

Will expenditures be held at or under current levels, or are inevitable increases already built into the budget? Can the increases in the deficits be financed without inviting inflation? Is there any prospect of budget balance in the reasonable future?

THE PROPOSED TAX PROGRAM

Purpose of the Program

In proposing a major revision of the Federal tax system, the President's tax message of January 24, 1963 emphasized that the changes attack "the most urgent task facing our nation at home today." The goals are described as (1) "to end the tragic waste of unemployment and unused resources;" (2) "to step up the growth and vigor of our national economy," (3) "to increase job and investment opportunities;" and (4) "to improve our productivity." The present tax structure is labeled as the largest single barrier to the achievement of these goals.

The benefits to the economy from adoption of this program are described as (1) a step up in total output and economic growth several times as great as the tax cut itself; (2) reduced unemployment; (3) maintenance of price stability; (4) improvement in the nation's balance of payments position; (5) a large increase in consumer purchases; (6) expansion of investment in new productive facilities as a result of growing consumer markets; and (7) an increase in revenues for state and local governments as national income expands.

Benefits to the taxpayer are listed as follows: (1) Wage earners and low income families will gain an immediate increase in take-home pay. "While tax rates are to be reduced for every bracket, the largest proportionate tax reduction properly goes to those at the bottom of the economic ladder." (2) Middle and higher income families will benefit by reduction of high rates. "This will restore an idea that has helped make our country great -- that a person who devotes his efforts to increasing his income, thereby adding to the nation's income and wealth, should be able to retain a reasonable share of the results." (3) Businessmen and farmers will benefit by a reduction in the corporate tax from 52% to 47% (4) Small businessmen will benefit by a reduction of 27% in the tax rate on the first \$25,000 on net income.

The Proposals

The tax proposals fall into five groups:

1. Reduction in individual income tax rates to a new scale of 14% to 65% over a three-year period, with the lowest \$2,000 income bracket divided in two.
2. Reduction in the corporate income tax from 52% to 47%, also in three stages; and reversal of the corporate normal and surtax rates.
3. Acceleration of corporate tax payments to a current basis, over a five-year transitional period (applies to corporations with tax liabilities of \$100,000 or more).
4. Removal of inequities and hardships, and broadening of the base of the income tax.
5. Revision of the tax treatment of capital gains.

The program would become fully effective on January 1, 1965. The rate reductions would total \$11 billion for individuals and \$2.6 billion for corporations, a total of \$13.6 billion. Reforms and revisions would recoup \$3.3 billion, reducing the revenue loss to \$10.3 billion in a full year. Furthermore, the speed-up of corporate tax payments would offset the loss by an additional \$1.5 billion annually for five years. Thus, the full-year revenue effect of the program when all the proposals are effective would be a reduction in revenues of \$8.8 billion.

In the fiscal year 1964, the revenue loss from rate cuts would be \$5.3 billion, balanced in part by accelerated corporation tax payments of \$1.3 billion. A "feed-back" in revenues from the economic stimulus to the economy is expected to reduce further the 1964 loss, so that the projected deficit from the tax program would add only \$2.7 billion to an administrative budget deficit of \$9.2 billion (projected without reference to any tax changes).

PROPOSALS FOR RATE REDUCTIONS

1. Reduction in individual income tax rates would lower the scale in three steps from the present level of 20% - 91% to a range of 14% - 65%. The first \$2,000 bracket of taxable income would be split with a lower rate applying to the first \$1,000. The proposed scale of rates for calendar 1963 is 18.5% to 84.5%, with a withholding rate of 15.5%. For calendar 1964, the rate scale would be from 15.5% to 71.5%, with a withholding rate of 13.5%. For calendar 1965, the scale would be 14% to 65%, the withholding rate being maintained at 13.5%. (Table 1).

2. Reduction in the corporate tax rate would not begin until January 1964. In calendar year 1963, the rates of the normal tax and surtax would be reversed; the normal tax would be 22% (permanently), and the surtax would be raised to 30%. In 1964 the surtax would be reduced to 28% (for a combined rate of 50%), and in 1965 the surtax would be reduced to 25% (bringing the combined corporate rate to the pre-Korean War level of 47%).

An affiliated group of enterprises (over a transitional period of five years) would be limited hereafter to one surtax exemption. Since affiliated corporations would now be treated as one entity for surtax exemptions and other purposes, the present tax of 2% for filing consolidated corporate returns would be abolished. Payment of corporate taxes would be stepped up over the next five years to a current basis similar to that now required of individual income taxpayers.

The reduction in corporate taxes would total \$2.6 billion. However, these reductions would be offset to the extent of \$1.5 billion per year (\$1.3 billion in 1964) by the speedup of tax payments during the next five years. The net effect (including structural reforms) would be an increase in corporate tax receipts of \$880 million in fiscal 1964, and a decrease of \$1,020 million a year when the rate reduction program is fully effective.

PROPOSALS FOR STRUCTURAL REVISION AND REFORM

A. Relief of Hardship and the Encouragement of Growth

Seven proposals are made, of which two are the most important:

1. A new minimum standard deduction of \$300 for each taxpayer, plus \$100 for each dependent (including his spouse) up to the present maximum of \$1,000. This would be equivalent to an increase of \$233 in the exemption for a single person. A married couple with two dependents would be taxed only on income in excess of \$3,000, as compared with \$2,666 under the present law. The new minimum standard deduction would provide about \$310 million of tax relief, primarily to those with incomes below \$5,000.

2. An important change is proposed in the tax treatment of older people. A credit of \$300 against taxes is proposed for all 65 or over, regardless of source of income, to replace both the extra \$600 exemption and the retirement income credit. This relief would favor taxpayers in lower and middle income brackets, and would cost \$320 million in revenue.

Four other changes are proposed in the taxation of individual incomes:

- a. a more liberal child care deduction (estimated to cost \$20 million);
- b. income averaging for those with fluctuating incomes under plans presented by the Secretary of the Treasury (revenue loss \$40 million);
- c. extend the exclusion of moving expenses to cover new employees as well as those moved in present jobs (\$50 million);
- d. extend the 30% of limitation on charitable contribution deductions to all organizations which are publicly supported and controlled. At present, an extra 10% deduction above the basic 20% limitation applies on contributions to churches, educational institutions and medical facilities only.

Finally, it is proposed that expenditures for machinery and equipment, used directly in research or development activities, be allowed as a current expense deduction as are other business expenses for research (revenue cost-\$50 million).

The entire group of so-called "relief" provisions would reduce revenues \$790 million in a full year.

B. Base Broadening and Equity

Nine changes are proposed, of which three have a major revenue impact:

1. A "floor" is proposed under itemized deductions of individuals equal to 5% of the taxpayer's adjusted gross income. (Itemized deductions such as taxes, interest, contributions, medical expenses and casualty losses would be deductible only to the extent that they exceed 5% of the taxpayer's adjusted gross income). This "broadening of the tax base," it is estimated, would induce an additional 6.5 million taxpayers to use the standard deduction, and would recoup \$2.3 billion of revenue.

2. Repeal of the dividend credit and exclusion is once more proposed, repeating the recommendation in the 1961 Tax Message. As before, it is estimated that \$460 million of new revenue would result.

3. A series of changes is recommended in the provisions dealing with natural resources. The principal one is a carry-over of development costs in computing the 50% net income limitation on percentage depletion. This proposal would apply only to expenditures made in taxable years beginning after December 31, 1963. Other proposals dealing with natural resources would eliminate the grouping of properties or leases in computing depletion and apply the 50% limitation to each lease or acquisition. The rules that "gains realized on sale" should be treated as ordinary income would be extended to mineral properties subject to depletion. Finally, depletion allowances and development costs in foreign operations of American oil companies would be restricted. These proposals are estimated to increase revenues by \$250 million.

Six other "base broadening and equity" provisions are suggested:

- a. A combination of the separate limitations of 3% on medical expenses and 1% on drugs into a new 4% "floor" under medical expense deductions;
- b. A similar floor of 4% of adjusted gross income under casualty loss deductions;
(Both the medical and casualty loss deductions would be subject to the general 5% floor on itemized deductions.)
- c. Repeal of unlimited charitable contribution deductions for the "handful" of taxpayers who avail themselves of it;
- d. Repeal of the \$100 per week sick-pay exclusion;
- e. Inclusion in employees' current income of the value of employer premiums for group term life insurance (with the exception of the first \$5,000 of coverage);
- f. A tightening of restrictions on personal holding companies.

The last five additional proposals would increase revenue by another \$330 million per year.

C. Revision of Capital Gains Taxation

The tax message recommends four changes in capital gains taxation:

1. The percentage of long-term capital gains includable in income would be reduced from 50% to 30%. Under the new 14% to 65% rate scale, the rates applicable to capital gains would thus be from 4.2% to a maximum of 19.5% (instead of the present 10% to 25%).
2. The holding period for long-term gains would be increased from six months to one year, and an indefinite carryover period for unabsorbed capital losses would be provided.
3. Net gains accrued on capital assets at the time of transfer at death or by gift would be taxed at capital gains rates. A series of exceptions (household effects, charitable bequests, transfer to spouse, and a blanket exemption) and special averaging provisions to spread the effect over a number of years were presented in detail by the Secretary of the Treasury.
4. Definitions of capital gains would be tightened to prevent the taxation of ordinary income as capital gain. Details presented by the Secretary of the Treasury covered real estate tax shelters, treatment of stock options, timber income and lump-sum pension and profit-sharing distributions.

The total revenue effect of the capital gains changes is expected to be an increase of \$100 million in revenue, a loss of \$450 million from the lower rates being over-balanced by the tax on assets transferred at death or by gift, and by the definitional changes. However, a strong point is made that the removal of the "lock-in" effect of the present law will result in a sharp increase in capital gains transactions, and this is expected to yield approximately \$650 million in new revenues.

OVERALL REVENUE EFFECTS

The details of the revenue effects of these changes in a full year of operation and for the fiscal year 1964 are shown in the attached Table 2.

EFFECTS ON THE BUDGET

Greater revenues are promised in the future, and it is expected that a substantial part of the future revenue will reduce the Federal deficit. The statement that the choice is between "chronic deficits" and "transitional deficits" is repeated and emphasized.

Furthermore, the program is represented as a fine balance between tax cuts needed to encourage growth and stimulate the economy, and the size of deficit we can afford. A smaller cut, it is argued, will not cope with the \$30-\$40 billion gap in the nation's economic performance. A larger cut would mean too great a deficit and would invite inflation.

A strong plea is made by the President for passage of the entire program in one bill, as quickly as possible. If the reforms proposed are not accepted by Congress, then equivalent increases in revenue or smaller tax cuts should be made so as not to change the deficit. Specifically, the President warns against failure to repeal the dividend credit and exclusion: if no action is taken on this recommendation, then a higher rate schedule scaled to a top rate of 70% would be appropriate. Similarly, the proposal to tax capital gains accrued at the time of transfer by gift or death is labeled an essential element of the program; in its absence "there would be no justification for any reduction of present capital gain rate schedules."

EFFECTS ON TAXPAYERS

The Treasury Department released a series of tables to accompany the President's tax message, comparing changes in individual tax liabilities under present law and under the proposed tax changes. In total, the tax liability of all individual taxpayers will be reduced by 18%. In the adjusted gross income class 0 to \$3,000, the reduction will be 40%. For all taxpayers in the adjusted gross income class of \$50,000 and over, the reduction in tax liability is 9% (Table 3).

The percentage decrease in tax liability for taxpayers using the standard deduction is shown as ranging from 77% at the lowest adjusted gross income class down to 20% at \$20,000. Other tables show the effects of applying the entire program of rate reduction and reform to typical taxpayers at various income levels who itemize deductions. Accepting the Treasury's assumptions as to the "typical" itemized deductions shown for married taxpayers with two dependents on these tables, the tax reduction when the full program is in effect will range from 18.7% at the \$5,000 level to 13.5% at the \$100,000 level. (Table 4). Smaller reductions apply in calendar 1963 and 1964.

* * *

Table 1

Comparison of tax rates under tax program and under present law
for married persons filing jointly

Taxable income ^a bracket (Thousand dollars)	:	Under present law	:	:	Under proposed program		
					Calendar year 1963	Calendar year 1964	Calendar year 1965

(.....percent))

0 - 2	20.0	18.5	15.5	14.0
2 - 4	20.0	19.0	17.0	16.0
4 - 8	22.0	21.0	19.0	18.0
8 - 12	26.0	25.0	22.0	21.0
12 - 16	30.0	28.5	25.5	24.0
16 - 20	34.0	32.0	29.0	27.0
20 - 24	38.0	36.0	32.0	30.0
24 - 28	43.0	41.0	36.0	34.0
28 - 32	47.0	44.5	39.5	37.0
32 - 36	50.0	47.5	42.5	40.0
36 - 40	53.0	50.0	45.0	42.0
40 - 44	56.0	53.0	48.0	45.0
44 - 52	59.0	56.0	50.0	47.0
52 - 64	62.0	59.0	53.0	50.0
64 - 76	65.0	62.0	55.0	52.0
76 - 88	69.0	65.5	58.5	55.0
88 - 100	72.0	68.0	61.0	57.0
100 - 120	75.0	71.0	62.0	58.0
120 - 140	78.0	73.0	64.0	59.0
140 - 160	81.0	76.0	65.0	60.0
160 - 180	84.0	78.0	67.0	61.0
180 - 200	87.0	81.0	68.0	62.0
200 - 300	89.0	82.5	69.5	63.0
300 - 400	90.0	83.5	70.5	64.0
400 and over	91.0	84.5	71.5	65.0

Office of the Secretary of the Treasury,
Office of Tax Analysis

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a) For single taxpayers half the amounts
in these brackets apply.

Table 2

Tax Program - Summary

Estimated revenue effect before feedback ^{1/}

(In millions of dollars)

	Calendar year liabilities		
	1963	1964	1965
I Individuals			
A. Rate reduction	-2,760	-8,280	-11,040
B. Structural reforms			
(a) Relief of hardship and encouragement of growth			
1. Allow minimum standard deduction	-	+ 310	+ 310
2. Liberalize child care deduction	-	+ 20	+ 20
3. Revise tax treatment of older people	-	+ 320	+ 320
4. Liberalize exclusion of moving expenses	-	+ 50	+ 50
5. Income averaging	-	+ 40	+ 40
6. Raise limitation on certain charitable contributions	-	*	*
7. Revise medical expense deduction	-	*	*
Total, relief of hardship and encouragement of growth	-	+ 740	+ 740
(b) Base broadening and equity			
8. 5 percent floor under itemized deductions	-	+2,280	+ 2,280
9. 4 percent floor under casualty losses	-	+ 90	+ 90
10. Repeal allowance of unlimited charitable contributions	-	+ 10	+ 10
11. Repeal sick pay exclusion	-	+ 160	+ 160
12. Repeal exclusion of premiums on group term insurance	-	+ 60	+ 60
13. Repeal of the dividend credit and exclusion	-	+ 460	+ 460
14. Revise taxation of natural resources	-	+ 10	+ 10
Total, base broadening and equity	-	+3,070	+ 3,070
Total, structural reforms	-	+2,330	+ 2,330
Total, individuals	-2,760	-5,950	- 8,710
II Corporations			
A. Rate revision			
1. Rate reduction and change in normal and surtax rates	- 450	-1,340	- 2,630
2. Limit surtax exemptions of affiliated groups ^{2/}	+ 120	+ 120	+ 120
3. Repeal 2 percent tax on consolidated returns ^{2/}	-	- 50	- 50
Total, rate revision	- 330	-1,270	- 2,560
B. Structural reforms			
(a) Relief of hardship and encouragement of growth			
1. Allow expensing of certain research and development costs	-	- 50	- 50
(b) Base broadening and equity			
2. Revise taxation of natural resources ^{3/}	-	+ 240	+ 240
3. Amend tax treatment of personal holding companies	-	+ 10	+ 10
Total, base broadening and equity	-	+ 250	+ 250
Total, structural reforms	-	+ 200	+ 200
Total, corporations before acceleration of payments	- 330	-1,070	- 2,360
C. Acceleration of payments	-	+1,300	+ 1,500
Total, corporations including acceleration of payments	- 330	+ 230	- 860
III Revision of taxation of capital gains and losses - individuals and corporations			
1. Reduce inclusion percentage and extend holding period	-	- 430	- 430
2. Allow indefinite carryover of losses	-	- 20	- 20
3. Tax net gains accrued at time of death or gift	-	+ 300	+ 300
4. Change definition of capital gains	-	+ 250	+ 250
Total (before induced effect of capital gains revision)	-	+ 100	+ 100
Induced effect of capital gains revision	-	+ 650	+ 650
Total, capital gains and losses	-	+ 750	+ 750
IV Total - before acceleration of corporation payments			
A. Rate reduction and revision	-3,090	-9,530	-13,600
B. Structural reforms including capital gains and losses	-	+3,280	+ 3,280
Total	-3,090	-6,250	-10,320
Total - including acceleration of corporation payments	-3,090	-4,950	- 8,820

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* Negligible

^{1/} At levels of income estimated for the calendar year 1963.^{2/} These two proposals must be considered jointly.^{3/} Full year effect; this will be reached gradually as the carryover increases.

Table 3

Tax program for individuals
Distribution by adjusted gross income class of the full year effect of
all tax changes directly affecting individuals ^{1/}

Adjusted gross income class (\$ 000)	Number of taxable returns (Millions)	Tax liability: under present law <u>2/</u>	Effect of tax program				Total tax under program
			Proposed rate change	Revisions	Total		

Amounts in millions of dollars

0 - 3	9.7	1,450	- 410	- 170	- 580	870
3 - 5	10.5	4,030	- 1,090	- 90	-1,180	2,850
5 - 10	22.9	18,300	- 4,520	+ 720	-3,800	14,500
10 - 20	6.7	12,710	- 2,690	+ 750	-1,940	10,770
20 - 50	1.0	6,760	- 1,410	+ 590	- 820	5,940
50 and over	.2	4,170	- 920	+ 530	- 390	3,780
Total	51.0	47,420	-11,040	+2,330	-8,710	38,710

Percent distribution by income class

0 - 3	19	3	4	- 7	7	2
3 - 5	21	8	10	- 4	14	7
5 - 10	45	39	41	31	44	37
10 - 20	13	27	24	32	22	28
20 - 50	2	14	13	25	9	15
50 and over	*	9	8	23	4	10
Total	100	100	100	100	100	100

Percent of tax liability under present law

0 - 3	-	100	-28	-12	-40	60
3 - 5	-	100	-27	- 2	-29	71
5 - 10	-	100	-25	+ 4	-21	79
10 - 20	-	100	-21	+ 6	-15	85
20 - 50	-	100	-21	+ 9	-12	88
50 and over	-	100	-22	+13	- 9	91
Total	-	100	-23	+ 5	-18	82

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^{1/} Excludes capital gains revisions. The net direct change is of minor revenue significance. The greater volume of transactions that can be expected will produce a revenue gain of \$690 million from individuals.

^{2/} Excluding tax on capital gains at 25 percent alternative rate.

* Less than .5 percent.

Note: Figures are rounded and will not necessarily add to totals.

Table 4

TAX LIABILITY OF MARRIED TAXPAYER WITH TWO DEPENDENTS,
WITH TYPICAL ITEMIZED DEDUCTIONS AND INCOME SOURCES

Adjusted Gross Income	Taxable Income		Tax Liability Under				Percent Reduction, Compared with Present Law		
	Present Law	Under proposed Reforms	Present Law	Recommended 1963 Rates ^a	Recommended ^a 1964 Rates	Recommended 1965 Rates	1963 ^a	1964 ^a	1965
\$ 5,000	\$ 1,500	\$ 1,750	\$ 300	\$ 278	\$ 271	\$ 245	7.3	9.7	18.3
\$ 7,500	3,600	3,975	720	674	646	596	6.4	10.3	17.2
\$ 10,000	5,800	6,300	1,196	1,128	1,087	1,014	5.7	9.1	15.2
\$ 15,000	10,050	10,800	2,213	2,102	2,026	1,908	5.0	8.4	13.8
\$ 20,000	14,300	15,300	3,410	3,246	3,132	2,952	5.1	8.2	13.4
\$ 50,000	40,100	41,655	14,198	13,520	13,064	12,265	5.0	8.0	13.6
\$100,000	81,600	81,665	37,560	35,922	33,906	32,436	4.4	9.7	13.6

^aComputed by Tax Foundation.

^bLess than 0.1 percent.