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TREASURY DEPARTMENT

WASHINGTON, D.C.

April 21, 1969

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SUMMARY OF TAX REFORM PROPOSALS

The President has recommended repeal of the 7% investment credit effective April 21, 1969. This means the credit will not be allowable for orders placed on April 21, 1969. This repeal permits his further recommendation of extension of the surcharge at a reduced rate of 5% for the period January 1, 1970, to June 30, 1970, instead of the 10% rate that is being recommended for the balance of the current year. The repeal will provide additional federal revenues for other important tax measures in the planning stage.

The following material is a brief summary of the tax reform proposals presented by the Treasury Department to the House Ways and Means Committee on April 22, 1969.

The net revenue change of the entire package will be small -- the revenue increases of reform measures will be largely offset by the revenue losses from the relief measures. A table showing the overall revenue effects of the entire package for the first full year and in the long run (1970 and 1975) is included.

THE PROPOSALS

I.

The Treasury recommends a general restriction on the net value of certain tax preferences in two respects:

Limit on Tax Preferences (LTP). A 50 percent ceiling would be imposed on the amount of an individual's total income which could enjoy tax preferred status. Total income for this purpose would be determined --

(1) By including appreciation in value of property given to charity;
(2) Before deducting intangible drilling expenses and percentage depletion in excess of cost depletion;
(3) Before deducting certain excessive farm losses;
(4) Before deducting the excess of accelerated over straight line depreciation on real estate.

The four preferences could not exceed half of total income. There would be a $10,000 minimum amount of allowable preferences. Thus, an individual with $100,000 of net business income, which reflects a deduction of $200,000 of accelerated depreciation on real estate in excess of straight line depreciation, would have adjusted gross income of $150,000 (in effect, $50,000 of the excess depreciation would become taxable).

A five-year carryover of disallowed tax preferences (an averaging device) would restrict the effect of this limit to persons who consistently have an excessive amount of these preferences. A three-year transition period, establishing the ceiling at 70 percent, 60 percent, and 50 percent, respectively, would phase in the limit gradually. When fully phased in, the revenue increase will be $80 million.

Allocation of Deductions. An individual with more than $10,000 of tax preferences would also be required to allocate his itemized (non-business) deductions between taxable income and the non-taxed or "allowable" portion of tax preference amounts. For this purpose, tax preferences would also include interest in state and municipal bonds and the excluded portion of long-term capital gains (50%). Thus, all itemized deductions could no longer be applied entirely against taxable income where there is also substantial non-taxable income.

The allocation will be phased in generally over a two year period. Thus, in the first year, only one-half total itemized deductions would be required to be allocated. When fully phased in, the revenue increase will be $500 million.

To provide essential relief to persons in poverty, we recommend a:

Low Income Allowance. An additional allowance would be granted to generally insure that families at the poverty level would not be required to pay any Federal income tax. This allowance, which would be automatically built into the tax tables, would completely exempt more than 2 million families from tax payments, effective at the following income levels:

No. of Exemptions	Income	No. of Exemptions	Income
Family of 1	$1,700	Family of 5	$4,100
2	2,300	6	4,700
3	2,900	7	5,300
4	3,500	8	5,900

The allowance would be phased out as income exceeded the above poverty levels at the rate of $.50 for each dollar of income over the levels. Thus, for a single person the allowance would not exempt income over $3,300; for a family of eight, it would phase out at $6,100. The allowance would be effective for 1970 and thereafter. The revenue loss from this change would be $700 million.

III

The Treasury also recommends the following reforms:

Mineral Production Payments. The tax treatment of mineral production payments would be changed. These "production payments," sold by oil companies and other mineral producers, represent in effect advance payment for future extraction of the minerals, and they are sold to accelerate income to avoid the statutory limitations on credits and deductions, such as the depletion allowance. Henceforth, these production payments will be treated as loans, which is their true substance. Similarly, the duplication of tax benefits by such persons in retaining and selling production payments in so-called ABC transactions will be dealt with in the same way. Bona fide production payments pledged for exploration or development will not be affected. The revenue increase after the first year will be $200 million.

Private Foundations and Exempt Organizations. Certain specific abuses by private foundations would be prohibited:

- -- self-dealing between the foundation and related parties
- -- failure to distribute real income annually to charity
- -- the control of operating business corporation (with a 5-year transition period for existing holdings)
- -- engaging in certain political activities, such as voter registration drives.

Penalties for these abuses would be imposed, and power would be given the United States District Courts, acting at the instance of the Justice Department in the absence of state action, to impose appropriate sanctions.

Foundations would also be required to make available for public inspection information as to grants to individuals, the activities of these individuals, and their work product.

Certain specific administrative changes would be made to provide much closer scrutiny and audit of foundation activities.

Present law taxing income from the direct operation of a business by certain tax-exempt organizations would be extended to churches and other tax-exempt organizations not currently covered. The investment income of social clubs and certain similar organizations, now untaxed, would be taxed. All tax-exempt organizations would be taxed on the income of any investment assets acquired with borrowed funds and not related to their tax-exempt functions (so-called Clay Brown bootstrap cases). The revenue increase from these various provisions cannot be estimated.

Charitable Contribution deduction:

The 30 percent limitation on charitable contribution deductions would be increased to 50%, to apply to all taxpayers beginning in 1969.

The unlimited charitable deduction available to certain persons who qualify in at least 8 out of any 10 years would be cut down. Thus, charitable contributions taken together with all other itemized non-business deductions could not exceed 80% of adjusted gross income.

In addition, a number of situation which allow different tax benefits for contributions depending on features of the property given or the method of gift require attention. Under present law, deductions for contributions to charity may be in the form of cash or property, taken at its fair market value.

Except with respect to donations of installment obligations, gain is not recognized to the donor on the making of the charitable gift. Treasury recommends that the deduction for charitable gifts of property, the sale of which would result in reducing income, be restricted to the cost or other basis of the property in the donor's hands. The effect is similar to taxing the appreciation of ordinary income assets in a charitable gift.

Treasury also recommends that no deduction be allowed for the rental value of property leased rent-free to a charity; and that no charitable deduction be allowed for gifts of stock rights unless the shareholder allocates the basis of his old stock in part to the rights which are given to charity.

Treasury also recommends that the special two-year charitable trust rule be repealed. The repeal will mean that in all cases a grantor will be taxed on trust income where a reversionary interest will or may be expected to take effect within ten years. Similarly, in the case of gifts of short term income interests to charity, the donor should not get a deduction unless he is taxable on the income.

Corporate Securities. In recent years there has been a rapid increase in the number and the size of mergers or other consolidations among corporations, particularly in the area of so-called "conglomerate" combinations. While the reasons for this development are principally non-tax, there are tax aspects which require change.

Treasury recommends legislative action on a number of issues, including the installment sales reporting treatment of capital gain recognized on the receipt of bonds, the treatment of original issue discount on bonds, and the interest deduction on the repurchase by a corporation of its own convertible bonds at a premium. In addition, Treasury is seeking to develop a regulation to distinguish debt from equity for purposes of the interest deduction.We consider this distinction is at the heart of the problem of the increased use of debt securities in these transactions.

While the measures recommended by the Treasury at this time are not specifically directed at acquisitions, whether of a conglomerate nature of otherwise, we believe that they will attack some of the basic tax problems involved in combinations and decrease the impetus toward creation of unusual security interests that are difficult for investors to evaluate. The Treasury is also undertaking a basic study of the general treatment of tax free corporate reorganizations.

Multiple Corporations. The advantage taken by a number of large corporations of certain tax relief provisions for small business, whereby a reduced corporate tax rate of 22 percent is applied to the first $25,000 of taxable income, would be ended. Corporate groups ranging up to hundreds of corporations would be consolidated into one for this purpose. The change would be phased in gradually over five years. The revenue increase from this change, when fully effective, will be $235 million.

Farm Income. Various provisions whereby farm deductions, frequently representing the cost of assets acquired, are offset against ordinary income, but the sale of farm assets is taxed only as capital gain, will be amended. The capital gain will be taxed as ordinary income to an appropriate extent. The hobby (gentleman farmer) loss rules preventing the consistent deduction of very large losses by individuals from certain enterprises would be strengthened. The revenue increase from these proposals has not been determined.

Accelerated Depreciation: Public Utilities and Others. Tax-free dividends presently being paid out of accelerated depreciation reserves, principally by public utilities but also by some other corporations, would be made taxable after a three-year adjustment period.

Federal and state regulatory commissions would be prevented from requiring a public utility to compute net income after tax for rate making purposes as if accelerated depreciation had been taken unless the utility voluntarily elects accelerated depreciation. Utilities are forced by the position of some commissions to claim accelerated depreciation to reduce their taxes, and the benefits are flowed through to the consumers at the expense of the Federal revenues generally. This rule will preserve the status quo and prevent further adoption by regulatory commissions of the "flow-through" concept except where the utility itself elects accelerated depreciation. This change will prevent an annaul revenue loss which could reach $1.5 billion if this limitation were not imposed.

Stock Dividends. The practice of a number of corporations issuing dividends in stock which increase the stockholder's interest in such a way that they are a substitute for cash dividends, rather than simply being a larger number of shares for the same interest, would be discouraged by making such dividends taxable. The Treasury proposal substantially follows the recommendation of the Advisory Group on Subchapter C, established by the House Ways and Means Committee in 1956. This provision will prevent a substantial future loss of revenue.

Capital Losses. Net long-term capital gains are in general taxed by including only one-half of the gain in ordinary income. A net long-term capital loss, however, may be deducted up to an annual limit of $1,000 in full against ordinary income. This is not only inconsistent but leads to tax planning of asset sales to separate gains and losses into alternate years. We recommend that each dollar of net long-term capital loss be permitted to offset only 50 cents of ordinary income. The limit of the annual deduction should be kept at $1,000 with the present unlimited carryover. In addition, married persons filing separate returns should be subjected to an annual limit of $500 each. In the long run this change will increase revenues by $100 million.

Restricted Stock Plans. During the past few years, there has been a rapid growth in the number of restricted stock plans. Under these plans, an employee receives stock or other property subject to restrictions on sale or other limitations. Because of these restrictions, tax is not imposed under existing rules until the employee sells the stock, and the amount then subject to tax is limited to the value of the stock when the employee received it. In effect, any increase in value during the period the restrictions are in effect is taxed only if the stock is sold, and then as a capital gain.

Treasury proposes that, as a general matter, where an employee receives stock or other property as compensation, he should be subject to tax when his rights in that property become nonforfeitable. When an employee receives nonforfeitable rights in property subject to restrictions on sale, these restrictions would be ignored, and the amount taxed would be the unrestricted full current fair market value of the property, unless the restrictions are bona fide limitations which continue for the life of the property.

Multiple or Accumulation Trusts. Under present law, income may be accumulated in trust and distributed to the beneficiary without tax to the beneficiary, with certain exceptions, even though that beneficiary pays higher tax than the trust itself. This enables creation of multiple trusts for the same beneficiaries to avoid the progressive rate structure.

Treasury proposes that all income accumulated in trust will be taxed at the beneficiary's regular rates when the income from the trust is received by the beneficiary. In addition, income accumulated in trust for the benefit of the grantor's spouse will be taxed to the grantor as earned, as it is under present law when it is accumulated for the grantor's own benefit. This provision will increase revenues by $70 million.

Moving Expenses. The deduction for moving expenses would be substantailly liberalized to include certain indirect costs, (house hunting trips, temporary living expenses at the new location and the cost of selling or buying a house) up to a maximum of $2,500, of which no more than $1,000 could be for the indirect costs. The higher limit would be available for the direct costs (the costs of buying or selling a house and lease breaking costs.) The revenue loss from this change would be $100 million.

Small Business Subchapter S Corporations. The existing rules permitting small business corporations to be taxed similar to partnerships to avoid the double tax on corporate earnings would be substantially liberalized by expanding existing size and types of income limitations, eliminating technical requirements, and simplifying their operation.

Extension of Special Treatment of Banks Holding Foreign Deposits.

Interest earned on U.S. bank deposits owned by foreigners not resident in the United States and not connected with a trade or business conducted here is exempt from income tax, and the bank deposits themselves are exempt from estate tax. However, existing law provided that these exemptions shall not continue beyond 1972. The expiration date was enacted in 1966 as part of the Foreign Investors Tax Act. At the time, the Congress was concerned that termination of the exemption would have an adverse impact on foreign balances in the United States and therefore deferred the effective date for terminating the exemption for five years.

The balance of payments continues to be a matter of concern. While we cannot forecast what the situation will be by 1973, it is clear that the scheduled termination will make a solution to the problem muchmore difficult to achieve. Accordingly, Treasury recommends that the Congress take action in accordance with the President's recommendation of April 4 that the scheduled termination of the exemption be repealed.

Table 1. -- Tax Reform Proposals

Estimated Increase or Reduction (-) in Calendar Year Tax Liabilities 1/

($ millions)

	1969	1970	Long-run effect 1975
1A. Limitation on tax preferences	20	40	80
1B. Allocation of deductions	275	500	500
2. Low income allowances	0	-665	-665
3. Mineral production payments	95	140	200
4. Foundations and exempt organizations	*	*	*
5. Charitable deduction changes	-10	-10	-10
6. Corporate securities	*	*	*
7. Multiple surtax exemptions	10	25	235
8. Farm income rules	0	10	50
9. Tax-free dividends from accelerated depreciation	0	0	80
10. Stock distributions	*	*	*
11. Capital loss limitation	65	80	100
12. Restricted stock plans	*	*	*
13. Multiple trusts	55	70	70
14. Moving expenses	-110	-100	-100
15. Subchapter S changes	*	*	*
Net increase (+) or reduction (-)	+400	+90	+540

1/ Based on current income levels with no provision made in long-run estimates for effect of income growth. Estimates include a 10 percent surcharge for 1969 and a 2 1/2 percent surcharge for 1970.

* No basis for estimating revenue effect. In some cases, however, these measures will prevent substantial future revenue loss.