GENERAL EXPLANATION

OF THE

TAX REFORM ACT OF 1976

(H.R. 10612, 94TH CONGRESS, PUBLIC LAW 94–455)

PREPARED BY THE

STAFF OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 29, 1976

GENERAL EXPLANATION

OF THE

TAX REFORM ACT OF 1976

(H.R. 10612, 94TH CONGRESS, PUBLIC LAW 94–455)

PREPARED BY THE

STAFF OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 29, 1976

U.S. GOVERNMENT PRINTING OFFICE

79-667 O WASHINGTON : 1976 JCS-33-76

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

Stock No. 052-070-03850-1

CONGRESS OF THE UNITED STATES

(94th Cong., 2d sess.)

JOINT COMMITTEE ON TAXATION

SENATE	HOUSE
RUSSELL B. LONG, Louisiana, Chairman	AL ULLMAN, Oregon, Vice Chairman
HERMAN E. TALMADGE, Georgia	JAMES A. BURKE, Massachusetts
VANCE HARTKE, Indiana	DAN ROSTENKOWSKI, Illinois
CARL T. CURTIS, Nebraska	HERMAN T. SCHNEEBELI, Pennsylvania
PAUL J. FANNIN, Arizona	BARBER B. CONABLE, JR., New York

LAURENCE N. WOODWORTH, *Chief of Staff*
HERBERT L. CHABOT, *Assistant Chief of Staff*
BERNARD M. SHAPIRO, *Assistant Chief of Staff*

LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., December 29, 1976.

Hon. RUSSELL B. LONG, *Chairman*,
Hon. AL ULLMAN, *Vice Chairman, Joint Committee on Taxation, U.S. Congress, Washington, D.C.*

DEAR MESSRS. CHAIRMEN: While committee reports explain the position of the House Committee on Ways and Means, or the position of the Senate Committee on Finance, they do not in all cases explain the tax legislation as finally passed by the Congress. This becames particularly important in the case of major legislation where there are many changes between the bill as passed by the House, or as passed by the Senate, and the bill which finally becomes public law. The Tax Reform Act of 1976, because of its comprehensive scope and because of the many changes which were made in this legislation, both by the Senate and subsequently by the conferees, is an illustration of where the differences were especially significant.

This document represents the effort of the staff of the Joint Committee on Taxation to provide an explanation of the Tax Reform Act of 1976 as finally enacted and is comparable to a number of similar documents prepared by the staff on other revenue acts in recent years. For the most part, where provisions which were unchanged in conference were described in either the House or Senate report, that explanation is carried over in this document. No attempt is made here to carry the explanation further than is customary in the case of committtee reports and therefore it does not deal with issues which are customarily explained in regulations or rulings.

The first major part of the document contains a summary of and the reasons previously given for the various provisions. The second part contains the revenue estimates on the legislation as finally enacted and the third part is a general explanation of the provisions appearing in the order in which they appear in the public law.

This material has been prepared by the staff of the Joint Committee on Taxation after the Tax Reform Act of 1976 was passed. It has not been reviewed by the tax committees and therefore only reflects the staff's view as to the intent of Congress. It is hoped that this document will be useful in gaining a better understanding of the Tax Reform Act of 1976.

Sincerely yours,

LAURENCE N. WOODWORTH,
Chief of Staff.

LEGISLATIVE HISTORY OF THE ACT

The Tax Reform Act of 1976 was the result of over two years of legislative deliberations largely during the 94th Congress, although some of the provisions were originally considered by the House Ways and Means Committee during the 93rd Congress.[1] Consideration of the Act in the 94th Congress proceeded on the following schedule:

June 23 through June 25, 1975: Panel Discussions before the House Committee on Ways and Means.

July 8 through July 31, 1975: Hearings before the House Committee on Ways and Means.

November 12, 1975: Bill (H.R. 10612) reported by the House Committee on Ways and Means (House Report 94–658).

December 3 and 4, 1975: Bill considered and passed by the House of Representatives.

March 17 through April 13, 1976; July 20 through 22, 1976: Hearings before the Senate Committee on Finance.

June 10, 1976: Bill reported by the Senate Committee on Finance (Senate Report 94–938): Supplemental report filed by Senate Committee on Finance on July 20, 1976 (Senate Report 94–938, Part 2).

June 16–18, 21–25, 28–30, July 1–2, 20–23, 26–30, and August 3–6, 1976: Bill considered and passed by the Senate.

September 13, 1976: Committee on Conference submitted Conference Report (House Report 94–1515; Senate Report 94–1236).

September 16, 1976: Conference report (and House Concurrent Resolution 751) approved by the House and Senate.

October 4, 1976: Tax Reform Act of 1976 (Public Law 94–455) signed by the President.

---

[1] The Ways and Means Committee did not report a tax reform bill in the 93rd Congress but did hold extensive discussions (February 5–28, 1973) and hearings (March 5 through May 1, 1973) on the subject. The Ways and Means Committee also held legislative markup sessions on tax reform late in the 2nd session (1974), but had only made tentative decisions prior to the end of the 93rd Congress. In addition, H.R. 17488, The Energy Tax and Individual Relief Act of 1974, reported by that committee on November 26, 1974 (House Report 93–1502), included provisions relating to real estate investment trusts and the taxation of foreign income, much of which was later included in the Tax Reform Act of 1976.

CONTENTS

I. SUMMARY AND REASONS FOR THE ACT

The Tax Reform Act of 1976 will serve six major purposes. First, it will improve the equity of the tax system at all income levels without impairing economic efficiency and growth. Second, the Act effects important simplifications of the tax system by modifying certain deductions and credits affecting individuals, by increasing the standard deduction to encourage taxpayers to switch from itemizing their deductions to using the standard deduction, and by redrafting complex provisions of the tax law and deleting obsolete and little used provisions. Third, the Act extends the fiscal stimulus provided by the Tax Reduction Act of 1975 and extended by the Revenue Adjustment Act of 1975, and makes permanent part of these tax cuts for individuals. Fourth, the Act encourages capital formation by extending the increased investment credit for four years, by modifying the application of the credit, by extending and revising the incentive for investing in employee stock ownership plans, and by liberalizing the net operating loss carryover. Fifth, it improves the administration of the tax laws by making it more efficient and strengthening taxpayers' rights. Sixth, the Act makes a major revision in the estate and gift taxes. It reduces the estate and gift tax for small- and medium-sized estates and at the same time eliminates tax avoidance possibilities.

In addition, the Act makes certain changes in the operation of the U.S. International Trade Commission as well as the withholding of preferential trade treatment for countries who aid or abet international terrorists.

A. TAX REVISION

While no one contends that our income tax system does not need improving, it is still widely acknowledged to be the best in the world. The difficulty faced in improving the system is that the American people want different things from their tax system. On the one hand, they want every individual and corporation to pay a fair share of the overall income tax burden. In a system that depends heavily on voluntary compliance with the tax laws, as ours does, tax equity is especially important. However, at the same time, Americans do not want the income tax system to interfere with economic efficiency and growth. This implies that tax changes to promote equity should not retard either the current recovery from what has been the worst recession since the 1930's or impede the long-run growth of the economy. The tax revisions in the Act represent a careful balance between these sometimes conflicting objectives.

The Act contains many tax revisions, described in more detail below, designed to eliminate tax abuses and make the tax system more equitable.

Tax shelter provisions

Congress believed that changes were needed to end the excessive tax deferrals provided by tax shelters, as well as the opportunity they provide to, in effect, convert ordinary income into capital gains. Too many investments have been motivated by excessive concern with the tax benefits associated with them, not their economic merits. In some cases, the manner in which the tax shelters were contrived was questionable even under prior law. In others, individuals were combining provisions of the law, or leveraging them through nonrecourse borrowings, in a way which multiplied severalfold any possible advantages intended by Congress. Such activities reduce citizens' respect for the income tax and represent an inefficient allocation of resources. The Act contains a number of provisions designed to curb these abuses without interfering with economically worthwhile investments.

The Act expands the use of the so-called "recapture" rules to prevent conversion of ordinary income into capital gains in the case of real estate, oil and gas drilling and sports franchises. For oil and gas drilling, farm operations, equipment leasing, and film purchases and production, losses from accelerated deductions are limited to the amount for which the individual is "at risk." This is designed to prevent leveraging of tax shelter benefits through the use of nonrecourse loans. There is also an "at risk" rule for limited partnerships in areas not specifically dealt with by the Act, which should discourage development of new leveraged tax shelters. In addition, in the case of farm syndicates (or passive farm partnerships) and motion picture production companies (and companies producing books, records, etc.), certain costs are required to be capitalized and written off over the productive period of the related assets, or the writeoff is delayed until the items involved are used. For real estate, the Act also requires capitalization of interest and taxes during the construction period.

The provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be allocated among the various partners according to whomever can maximize the tax benefits unless such allocation has substantial economic effect. Also, limits are placed on the amount of "bonus" first-year depreciation deductions of the partners. The Act requires prepaid interest to be deducted over the period to which it relates and requires use of accrual accounting by many farm corporations. Also, it tightens the existing limit on deductions of excess investment interest.

Minimum and maximum taxes

Congress believed that high-income people and corporations should not be able completely to escape liability for income tax. Preventing this is a major feature of the Act. It greatly reduces the incidence of tax avoidance by high-income people through two related provisions—a stiffer minimum tax on tax-preferred income and a revision in the maximum tax designed to discourage use of tax preferences.

Minimum tax

The prior minimum tax for individuals was inadequate. In 1974 it raised only $130 million, down from $182 million in 1973, which is only a small fraction of total tax-preferred income. Also, the minimum tax for individuals was largely a tax on one preference—the excluded half of capital gains. The Act amends the minimum tax both to increase its revenue yield and to broaden the tax preferences covered by it.

The Act raises the minimum tax rate from 10 percent to 15 percent. In place of the existing $30,000 exemption and the deduction for regular income taxes, the Act has an exemption for individuals equal to one-half of regular income taxes or $10,000, whichever is greater. These changes reflect Congress' view that the effective tax rate on tax preferences should be higher.

Two new minimum tax preferences are added. To reduce the tax benefit of shelters in oil and gas drilling and to ensure that oil drillers pay some minimum income tax, the Act adds a preference for intangible drilling costs. To impose some tax in cases where there is excessive use of itemized personal deductions, there is a new preference for itemized deductions (other than medical expenses and casualty losses) in excess of 60 percent of adjusted gross income.

Congress also believed that the minimum tax on corporations should be strengthened in order to raise the effective tax rate on corporate tax preferences. However, because corporate income is subject to both the individual and corporate income taxes, Congress felt it was appropriate to retain in full the deduction for regular taxes for corporations.

Maximum tax

In 1969, Congress enacted a 50-percent maximum marginal tax rate on income from personal services. To reduce the incentive to invest in tax shelters, the law provided that income eligible for this maximum rate be reduced by tax preferences (as defined under the minimum tax) in excess of $30,000. The Act extends this 50-percent maximum rate to deferred compensation (including pensions and annuities).

The "preference offset" in the maximum tax has not been as effective in discouraging investment in tax shelters as originally planned. The expanded list of minimum tax preferences will make the preference offset more effective. Also, the Act repeals the existing $30,000 floor on preferences that reduce personal service income eligible for the maximum tax.

Business expenses under the individual income tax law

Many individuals are now claiming deductions for the business use of their home, for expenses related to the rental of their vacation homes for a brief part of the year, or for expenses of attending foreign conventions. While in theory there is nothing wrong with appropriate deductions for business or investment expenses, in practice it is often extremely difficult to allocate between deductible business expenses and nondeductible personal expenses. The result is that many people have been deducting amounts as business expenses which in part actually represent personal expenses. To deal with this problem, the Act places strict limitations on these deductions.

The Act also repeals the special tax treatment for qualified stock options. With personal service income subject to a maximum rate of 50 percent, Congress decided that there is no reason for not taxing this form of compensation as ordinary income.

Tax treatment of foreign income

The Act makes several important changes in the tax treatment of foreign income. Congress believed that it is necessary to strike a delicate balance between encouraging the free flow of capital across national borders and making sure that the tax laws do not provide excessive incentives for foreign investment instead of investment in the United States. Congress decided to retain the basic structure of the taxation of foreign income—namely, a foreign tax credit for income earned abroad and deferral of tax on income of foreign subsidiaries (except in the case of "tax haven" income) until returned to this country. However, the Act eliminates virtually all other tax-related incentives for investment abroad.

An important change made by the Act is the repeal of the per-country limitation on the foreign tax credit. The per-country limit enables a firm with a loss in one country and a profit in another to deduct the loss against U.S. income and still avoid U.S. tax on the profit through the foreign tax credit. Its repeal will eliminate this possibility and will also greatly simplify this part of the tax law. The Act also provides for recapture of foreign losses deducted from U.S. income when foreign profits are earned in subsequent years.

The Act repeals numerous tax incentives which favor investment in some foreign areas over others—those which favor investment in less-developed country corporations, China Trade Act corporations and Western Hemisphere trade corporations. It also substantially revises and improves the tax provisions relating to U.S. possessions. Except in the case of U.S. possessions, Congress felt that there was no longer any good reason for favoring investment in one of these foreign areas over another.

The Act, while retaining an exclusion for income earned abroad by individuals, eliminates special features of this provision enabling those with income above the basic exemption levels to obtain additional tax benefits from the exclusion and reduces the maximum amounts eligible for the exclusion. Congress did not feel that the tax preference for income earned abroad should be as large as it was under prior law.

Another area of concern is the DISC provision that permits deferral of tax for one-half of export income. To make this incentive more efficient, the Act limits DISC treatment to the excess of a firm's exports above a moving base period level.

Congress did not believe that multinational corporations should benefit from tax incentives when they engage in misconduct. Thus, the Act denies the foreign tax credit, tax deferral, and DISC treatment for income earned in connection with participation in international boycotts, such as the Arab boycott of Israel. Similarly, it provides that amounts paid as bribes by foreign subsidiaries will be taxed to the U.S. parent corporation.

To eliminate the possibility that oil companies which operate abroad gain undue advantage from the characterization of their payments to foreign governments as creditable taxes, the Act further limits the extent to which foreign tax credits from oil extraction can be used while continuing the requirement that these taxes may not reduce the tax on other foreign oil income.

The Act also makes several technical corrections that were considered necessary resulting from the changes in the taxation of foreign income made by the Tax Reduction Act of 1975.

Capital gains and losses

The Act makes three important changes in the tax treatment of capital gains and losses. The holding period defining long-term capital gains, which receive preferential tax treatment, is raised (over a period of two years) from six months to one year. This should encourage longer term investments as contrasted to short-term speculative investments. Also, the Act (over a period of two years) increases the amount of ordinary income against which capital losses can be deducted from $1,000 to $3,000. This change is designed to provide relief to those who have capital losses in excess of capital gains, which is not only fair but also should encourage individuals to make equity investments. Finally, the Act increases the exemption level for capital gains on the sale of a principal residence by a taxpayer age 65 or over.

Other tax revisions

The Act makes a large number of other relatively minor revisions in the tax law. These deal with inequities or technical problems that have come to the attention of the Congress.

There are several provisions relating to tax-exempt organizations. Among these is one which sets the payout requirement (if larger than actual earnings) for foundations at 5 percent of asset value (instead of a minimum of 6 percent) and provides that this limit is not to be varied as interest rates generally change. A second provision sets up a court review procedure where the IRS holds that an organization does not qualify for exempt status. A third change makes more specific the rules for lobbying by charitable and educational organizations.

234-120 O - 77 - 2

The Act includes a number of provisions relating to pensions. Probably the most important of these is one which expands the existing provision for individual retirement accounts (IRAs) to permit a working spouse to set up an IRA for a nonworking spouse. This change recognizes the contributions to the family made by nonworking spouses. If an IRA is set up for both spouses, a $1,750 contribution limit applies. Contributions can be made, subject to that limit, to a single IRA with separate subaccounts or two separate IRAs. Another pension provision permits an amount of up to $750 to be set aside each year in an H.R. 10-type plan where income is $15,000 or under without the amount set aside being limited to 25 percent of an individual's earnings.

There also are a number of changes relating to the taxation of insurance companies. Among these is one which, after a period of five years, will permit casualty insurance companies to file consolidated returns with life insurance companies but in a manner which does not permit the losses of the casualty companies to remove more than a limited amount of the life insurance income from taxation.

There are technical changes in the tax treatment of real estate investment trusts, housing cooperatives and condominiums, certain franchise transfers, authors and publishers, creditors of political parties, subchapter S corporations, the work incentive (WIN) tax credit, personal holding companies, oil and gas producers, losses from disasters, simultaneous liquidation of parent and subsidiary corporations, gain from sales or exchanges between related parties, and deductions for removing architectural and transportation barriers for handicapped and elderly people.

The Act makes revisions in depreciation rules designed to encourage rehabilitation of historic structures.

Several tax provisions that have recently expired are extended in the Act. These include rapid amortization provisions for pollution control facilities and rehabilitated low-income housing. Pollution control facilities are also given half of the normal investment credit, which differs from the prior provision under which 5-year amortization was an alternative to the investment credit. Congress believed that since Federal regulations require installation of pollution control equipment, it is equitable to reduce the cost of capital for such equipment. Also, the exclusion from income for certain forgiven student loans is extended through 1978. Further, the Act extends for a limited period the exclusion for certain health-related scholarships for members of the uniformed services for those participating in 1976.

Tax exemption is provided for contributions by employers to qualified group legal services plans, designed to encourage use of this fringe benefit.

To broaden the market for State and local government bonds, mutual funds are allowed to pass through tax-exempt interest on such bonds to shareholders.

Also, the Act redefines income or loss from writing options as short-term capital gain or loss in order to limit the tax shelters that have developed in recent years in stock option hedges.

In addition, the Act makes certain small changes in the excise tax treatment of truck modifications and truck parts and accessories, and simplifies and revises the excise tax treatment of cigars.

B. TAX SIMPLIFICATION

Tax simplification is the second major goal of the Act. Simplification must be an ongoing process, and the individual provisions of the tax law must be reexamined periodically to see how they contribute to the complexity of the tax law. Unless this reexamination occurs, the tax law will grow gradually more complicated as new provisions are added to achieve new goals of society. The Act repeals or restructures several provisions of the tax law, and directs that a Congressional study be made regarding further simplification of the tax system.

One such provision concerns the use of the income tax tables. The Act eliminates the existing tax tables based on adjusted gross income, which have been a major source of taxpayer error, and substitutes a simpler set of tables based on taxable income. It also raises to $20,000 the taxable income level where these tax tables may be used.

A second simplification concerns the retirement income credit. This was originally designed to give those who retire without social security a tax benefit similar to that accorded social security benefits. As a result, eligibility for the credit and its computation were designed to follow as closely as possible eligibility for, and computation of, social security benefits. This required a complex form that filled a whole page, and it is estimated that a large fraction of the people eligible for the credit either did not claim it or made errors in computing it. In response to this problem, Congress restructured the credit to eliminate virtually all the complexity, even though this means breaking the close link between the retirement income credit and social security eligibility. This new credit for the elderly also will be fairer than the retirement income credit under prior law since it will also be applicable to earned income for taxpayers age 65 or over.

Another complicated provision has been the sick pay exclusion. In this case, Congress concluded that the exclusion should be allowed only for persons who are permanently and totally disabled, since for other people there is no reason why sick pay should be treated more favorably than wage income, particularly in view of the deductibility of medical and drug expenses. For those still eligible for the sick pay exclusion, the provision has been considerably simplified and coordinated with the new credit for the elderly.

The Act makes major changes in the treatment of child and dependent care expenses. Formerly, these were allowed as an itemized deduction, subject to some complicated limitations. The Act converts the deduction into a 20-percent credit, so that it will be available to those who use the standard deduction as well as to itemizers and so that it will provide the same tax relief to taxpayers in low brackets as to those in high brackets. The child care deduction in prior law was worth, for examp'e, 70 cents for each dollar of child care expenses for a taxpayer in the 70-percent bracket, but only 14 cents to a low-bracket taxpayer who itemized deductions and nothing to someone who used the standard deduction. The new credit will be worth 20 cents for each dollar of qualified child care expenses for all taxpayers. In addition, the Act significantly simplifies the child care provision and broadens eligibility for it.

The Act makes several other changes that will simplify the law or make it more equitable, including a revision of the rules relating to accumulation trusts and the moving expense deduction. The alimony deduction is moved from an itemized deduction to a deduction in determining adjusted gross income, so that it can be used by people who take the standard deduction.

There are some cases where it is possible to achieve tax simplification without changing the substance of the law. The Act includes the so-called "deadwood provisions" which deletes obsolete and rarely used parts from the Internal Revenue Code and makes many other changes to shorten and simplify the language of the Code.

These provisions are only the beginning of what must be a continual process of tax simplification. Congress plans further tax simplication measures and has directed the Joint Committee on Taxation to conduct a comprehensive study of ways to simplify the tax system (with a report to the House Ways and Means and Senate Finance Committees due by June 30, 1977).

C. EXTENSION OF TAX REDUCTIONS

Economic conditions

A third major purpose of the Tax Reform Act of 1976 is to extend the fiscal stimulus provided by the Tax Reduction Act of 1975 and subsequently extended for the first half of 1976 by the Revenue Adjustment Act of 1975. The Tax Reduction Act of 1975 provided a tax cut, a tax rebate and increased expenditures totaling $23 billion in 1975.[1]

The 1975 tax cut included a temporary increase in the standard deduction and a $30 nonrefundable tax credit for each taxpayer and dependent, which reduced tax liability by $8 billion and was reflected in lower withheld and estimated tax payments over the last 8 months of 1975. There was also an earned income credit involving $1.4 billion and a home purchase credit amounting to about $0.6 billion. Finally, there were business tax reductions—an increase in the investment tax credit and a corporate rate cut for small businesses—amounting to $5 billion.

The 1975 increase in the standard deduction and the $30 credit, which reduced tax liability by $8 billion, were reflected in lower withheld and estimated tax payments over the last 8 months of 1975 at the rate of $1 billion per month, or $12 billion per year. In the Revenue Adjustment Act of 1975, Congress decided to extend these same withholding rates for the first half of 1976 and to provide a cut in tax liability for 1976 approximately equal to this $6 billion reduction in withholding. Also, that Act extended the small business tax cuts and the earned income credit for the first half of 1976. (The increase in the investment credit had been put into effect for 1975 and 1976 in the Tax Reduction Act.)

Congress analyzed economic conditions again in 1976 and believed it was inappropriate to withdraw the economic stimulus provided by the 1975 tax reductions. Due in no small part to the 1975–76 tax reduc-

[1] This included a rebate on 1974 individual income taxes of $8.1 billion plus a $50 one-time payment to social security recipients and increased unemployment compensation amounting to $2 billion.

tions, there has been an overall economic recovery from the 1974–75 recession in the past 18 months. Output has grown at a rate of more than 6 percent, and we have exceeded the level of income and production that existed at the end of 1973, prior to the recession. Since then, however, the capacity of the economy has grown and will continue to grow, and the economic forecasts examined by Congress indicated that there is likely to be excess capacity in the economy for at least the next year. While the unemployment rate had fallen from 9 percent to 7.8 percent (at the time of passage of the Tax Reform Act), the existing unemployment rate was still considered to be unacceptably high. For these reasons, Congress agreed to extend the existing tax cuts at least through 1977 and to make part of the tax cuts permanent.

Congress did not believe that a permanent extension of the entire $20 million in tax reductions then in effect was appropriate. There was uncertainty about just how much excess capacity there was (or was likely to be) in the economy, how serious the inflation problem would be in the years ahead, as well as what budgetary requirements would be necessary for the rest of the decade.

In view of the uncertain economic and budgetary situation, Congress agreed to make part of the $20 billion tax reduction permanant but to extend the rest only temporarily. This will afford Congress and the Administration an opportunity in 1977 to review economic conditions and the fiscal requirements to see what, if any, further extensions or enlargements of these tax cuts should be made.

Individual tax reductions

The Act makes permanent $4 billion of individual tax reductions. These result from the increases in the standard deduction. The Act extends through 1977 the general tax credit adopted in the Revenue Adjustment Act and the earned income credit, which together involve a tax cut of $11 billion for 1977.

The Act permanently increases the minimum standard deduction (or low-income allowance) from $1,300 to $1,700 for single returns and to $2,100 for joint returns. It increases the percentage standard deduction from 15 percent to 16 percent. Also, it increases the maximum standard deduction from $2,000 to $2,400 for single returns and to $2,800 for joint returns. This will reduce tax liability at an annual rate of $4.2 billion for 1977, and will lower budget receipts in fiscal year 1977 by $4.1 billion. This increase in the standard deduction represents a major simplification of the individual income tax, since it will make it worthwhile for filers of 9 million tax returns to switch to the standard deduction. Also, this change creates greater tax equity, since itemized deductions have been free to rise with inflation, while the minimum and maximum standard deductions stay constant unless there is specific legislative action.

There is also an extension of the earned income credit through 1977. This is a refundable credit equal to 10 percent of the first $4,000 of earnings, with a phaseout as income rises between $4,000 and $8,000. It is available only to people with dependent children. It involves a cut in tax liability in 1977 at a rate of $1.3 billion, and a reduction in fiscal year 1977 budget receipts of $0.7 billion. The earned income credit provides a work incentive for those with jobs that pay relatively low wages. It provides desperately needed tax relief to a hard-pressed group, who are faced with high food and energy prices and are subject to the payroll tax.

The Act extends through 1977 the general tax credit for individuals adopted in the Revenue Adjustment Act, which reduces tax liability in 1977 at an annual rate of $10.1 billion. The extension of this credit will reduce fiscal year 1977 receipts by $9.5 billion. This credit equals the greater of $35 for each taxpayer and dependent or 2 percent of the first $9,000 of taxable income.

Together, the individual tax cuts amount to a cut in tax liability in 1977 at an annual rate of $15.6 billion. They will reduce budget receipts in fiscal year 1977 by $14.4 billion.

Business tax reductions

In order to provide sufficient economic stimulus and to encourage businesses to invest, the Act extends the business tax cuts provided by the Tax Reduction Act of 1975. These reduce tax liability in 1977 at an annual rate of $5.4 billion and will reduce tax receipts in fiscal year 1977 by $3.0 billion.

As discussed later under *Capital Formation*, the Act extends through 1980 the current 10-percent investment credit (applicable previously through 1976). This represents an increase from the previous 7-percent rate for most businesses and from the 4-percent rate for public utilities. These changes will reduce tax liability by $3.3 billion in 1977, and will lower budget receipts by $1.3 billion in fiscal year 1977.

The investment credit has proven an effective way to stimulate investment in equipment. Its enactment in 1962 and its reenactment in 1971 were followed by investment booms, and its suspension in 1966 and repeal in 1969 were followed by sharp declines in investment. Increased investment in the U.S. economy is needed to improve our standard of living and to achieve energy, environmental and other goals; and under these circumstances, Congress believed an extension of the 10-percent investment credit was appropriate. The credit for utilities is increased to the same rate as that for other businesses because Congress believed they should be able to compete for capital on the same basis as other industries.

The Act also extends through 1977 the small business tax cuts enacted in 1975. These increase the corporate surtax exemption from $25,000 to $50,000 and reduce the tax rate on the initial $25,000 of corporate income from 22 percent to 20 percent. The reduction in tax liability is $2.1 billion in 1977, and the reduction in budget receipts is $1.7 billion in fiscal year 1977. This change will improve the competitive position of small business.

D. CAPITAL FORMATION

A fourth major aspect of the Act is the encouragement of capital formation through the continuation and modification of certain investment-related tax incentives. Congress was concerned that the U.S. economy faced a severe shortage of capital. In 1973 and early 1974, there were capacity shortages in many major industries because investment in them had been inadequate in the previous five years. Also, the growth rate of labor productivity has slowed, again partly because of inadequate capital investment. We have had the most success in stimulating capital investment in recent years by the use of the investment tax credit. There appears to be a close correlation since 1962 between the presence of the investment credit and purchases of equipment. As a result, the Act extends the 10-percent investment credit for four years (or through 1980).

The Act extends and expands a provision enacted in 1975 allowing an additional one-percent investment credit if an equivalent amount is placed in an employee stock ownership plan. These changes should significantly increase the extent to which the provision is used by business. Under the new law, a credit of an additional one-half percentage point is also allowed if it is matched with employee contributions. This option is considered desirable in order to broaden employees ownership in business and thereby increase their interest in improving productivity. It will also serve the twin goals of increasing capital accumulation and creating a more equal distribution of wealth. To make the investment credit available to less profitable businesses, the Act makes it available on a first-in, first-out basis.

Another provision to promote capital accumulation, which will be especially important for new business, is one that extends the net operating loss carryforward period to 7 years. By allowing more flexibility in averaging profits and losses, this will encourage risktaking. It will also encourage investment in new businesses. The Act tightens the existing rules to prevent "trafficking" in losses in order to reduce any tax incentives toward business mergers. In addition, the capital loss carryover period for mutual funds is extended from 5 years to 8 years.

For railroads and airlines, industries which have had trouble generating internal funds as a result of the recession, the Act provides (for a limited period of time) a tax reduction through changes in the investment credit and in amortization rules. For similar reasons, at least half investment credit is made available to the domestic merchant marine for funds withdrawn from their tax-deferred ship construction fund to purchase ships.

Finally, the Act, in order to encourage domestic production, makes the investment credit available in the future for motion picture productions only where they are predominantly American-produced films. For the past, a compromise between the Internal Revenue Service and the industry is worked out as to the appropriate investment credit intended under the relatively uncertain provisions of prior law.

E. ADMINISTRATIVE PROVISIONS

A fifth major goal of the Act is to improve the administration of the tax laws. It contains several provisions to improve efficiency of tax administration through changes in withholding provisions and better regulation of tax return preparers. It also makes significant administrative changes designed to strengthen taxpayers' rights.

The Act provides definitive rules relating to the confidentiality of tax returns, an area where there has been abuse in the past. It strictly limits disclosure of information from tax returns. The ability of the Internal Revenue Service to use jeopardy and termination assessments and to issue administrative summons also is limited by providing better court review in these cases.

At the same time, rules are provided for the publication of private letter rulings so everyone will have an equal opportunity to know the view of the IRS on the proper interpretation of the tax law. New rules are also added to aid the Service in reviewing the way in which tax return preparers carry out their duties.

In the case of withholding tax provisions, a number of changes are made, including provision to withhold at the rate of 20 percent on income from most wagering where the amount won is $1,000 or over. Further, in the case of fishing vessels where the catch is shared, sternmen are classified as independent contractors for tax purposes. The Act also provides mandatory withholding of State and local income taxes for members of the Armed Forces.

F. ESTATE AND GIFT TAX PROVISIONS

The estate and gift tax provisions provide a comprehensive revision of these taxes. In this area, the Act provides substantial relief for moderate-sized estates, farms and other closely-held businesses, alleviates the liquidity problem for estates comprised largely of farms and other closely-held business, while at the same time it removes tax avoidance devices from the present system. This is accomplished with a balanced set of provisions which in the long run will at least maintain the present level of revenues.

The Act substantially reduces estate taxes for medium-sized estates. The existing $60,000 estate tax exemption was enacted in 1942 and since that time the percentage of decedents whose estates have been subjected to the Federal estate tax has increased from 1 percent to 8 percent. This increase has resulted from inflation and the greater ability of people to accumulate wealth because of the unprecedented economic prosperity in the post-war era. The Act increases from $60,000 to $175,000 the level at which the taxation of estates begins. It also changes the exemption into a tax credit in order to confer the maximum possible tax relief on the small and medium-sized estates.

In addition, the prior estate tax imposed acute problems when the principal asset of the estate was equity in a farm or small business. Because assets are valued at their "highest and best use" for estate tax purposes, rather than on the basis of the specific use to which the assets were being put (and also because these assets are illiquid), family members have often been forced to sell farms and small businesses in order to pay the estate tax. To deal with these problems the Act allows farms (and other family businesses) to be valued (to the extent of $500,000) at the value for farming purposes (or other small business use), if they remain in the family for a period of ten to fifteen years after the death of the decedent, rather than being valued at the "highest and best use" market value. Also, in these cases, the Act extends the time for payment of estate tax liability and provides for a low 4-percent interest rate on the tax on up to $1 million of farm or small business value. These changes are intended to preserve the family farm and other family businesses—two very important American institutions, both economically and culturally.

The estate and gift tax structure is an important part of the Federal tax system and as such needs to be as nearly equitable as possible in its application. Tax liability should not depend on the method used to transfer the property from one generation to the next. Because of this, a number of steps were taken to reform the estate and gift tax provisions. This reform provides assurance that in the long run these provisions will not lose revenue.

Two features of prior law which give rise to considerable variations in estate and gift tax burdens for people who transfer the same amount of wealth were the separate rate schedule and exemption provision for estates and gifts. There were several tax advantages to lifetime gifts. The gift tax rates were 75 percent of estate tax rates; and, unlike the estate tax, the amount of the gift tax itself was not included in the tax base. Also, someone who split his total transfers between gifts and bequests achieved the advantage of "rate splitting," since the first dollar of taxable bequests was taxed at the bottom estate tax rate even where there had been substantial lifetime gifts. These opportunities for reducting the overall burden by lifetime giving were inequitable, especially since many people are not wealthy enough to make lifetime gifts. The Act unifies the estate and gift taxes—both the exemptions (which have been converted into a credit) and the rates—to deal with these inequities.

Another cause of unequal treatment of taxpayers with the same amount of wealth transfers has been the ability to use "generation skipping" trusts. When weath is bequeathed from the parent to his child, then from the child to a grandchild and finally from the grandchild to a great-grandchild, the estate tax is imposed three times. However, if the parent places the wealth in a trust in which the child and then the grandchild has the right to the income from the trust, with the principal going to the great-grandchild, the parent will achieve virtually the same result and, in effect, skip two generations of estate tax. In these cases, the estate tax could be avoided for 100 years or more under prior law. Since such trust arrangements have been used largely by wealthier people, this failure to tax generation-skipping trusts has undermined the progressivity of the estate and gift taxes. The Act significantly limits estate tax avoidance through generation-skipping trusts by imposing a tax at the time of the death of the child or grandchild, in the example cited above, of substantially the same size as would be imposed had the property passed directly from the child to the grandchild and to the great-grandchild, although the additional tax in this case is payable by the trust. However, an exception to this rule is provided for up to $250,000 passing from a child to one or more grandchildren.

Still another inequity in the prior law resulted from the fact that when appreciated property was transferred at death, the basis of the property for the heirs (on which any capital gain or loss is computed) was the fair market value at the time of death rather than the basis of the decedent. This contrasted with the rule for gifts, where the donee must carry over the basis of the donor. One unfortunate result of the prior law has been that people were reluctant to sell appreciated property in anticipation of the step-up in basis at death. Another result has been that assets accumulated out of savings from ordinary income bore a heavier total tax burden than those resulting from appreciation in value where the gain had not been realized. To reduce the inefficiency and inequity of the prior system, the Act generally provides for a carryover basis at death but provides, however, that there will continue to be a step-up in basis for appreciation which has occurred through the end of the calendar year 1976.

G. INTERNATIONAL TRADE AMENDMENTS

Another area of the Act involves changes in the operation of the U.S. International Trade Commission and amendments to the Trade Act of 1974 regarding tariff treatment of countries aiding or abetting international terrorists.

The Congress concluded that the voting procedures of the International Trade Commission needed revising in order to facilitate the functioning of the Congressional override mechanism in cases where a plurality of three commissioners reached agreement on a particular remedy but, because a majority of the commissioners voting did not agree on a remedy, there was no "recommendation" by the Commission which Congress could implement under the override provisions (contained in the Trade Act of 1974). Thus, the Act provides that if a majority of the Commissioners voting on an escape clause or market disruption case cannot agree on a remedy finding, the remedy finding agreed upon by a plurality of not less than three Commissioners is to be treated as the remedy finding of the Commission for the purposes of the Congressional override mechanism. The Act also modifies the rule for the term of office for a member of the Commission so that a Commissioner may continue to serve after the expiration of the term of office until the successor is appointed and qualified.

In addition, the Act amends the Trade Act of 1974 to add a new category of reasons for denying preferential tariff treatment to "beneficiary developing countries." The new provision would prohibit preferential tariff treatment to such countries that aid or abet any individual or group which has committed an act of international terrorism. The President, however, could waive this prohibition (as he may for certain of the other categories for denial of preferential treatment) if a waiver is determined to be in the national economic interest of the United States.

or services in the ordinary course of their trade or business. Thus, the receipts giving rise to the debt must have been taken into income in order for the deduction to be obtained.

The Act limits this exception to those cases in which 30 percent of all of the receivables accrued in the ordinary course of all of the trades or businesses of the taxpayer are due from political parties. Thus, the exception is limited to those taxpayers whose sales to political parties (including political campaigns and candidates) constitute a major portion of their trades or businesses. In determining the amount required to meet the 30 percent rule, all of the taxpayer's trades and businesses are to be considered. Thus, in the case of an individual, every trade or business which the taxpayer controls is to be aggregated for purposes of this test. In the case of a taxpayer which is a corporation, every trade and business of all corporations under common ownership with the taxpayer is to be aggregated.

The bad debt deduction is to be allowed only if the taxpayer has made substantial continuing efforts to collect on the debt. Thus, a taxpayer must make good faith efforts over a period of time to collect the debt and must be able to document those efforts. However, it is not intended that a taxpayer is required in any case to file a lawsuit against the debtor in order to be determined to have made substantial continuing efforts.

The Congress affirmed that the provision of prior law was not intended to apply to taxpayers whose primary business is to provide goods or services to political parties. The changes made by the Act thus reflect Congress' original intent in enacting prior law.

Effective date

This provision is to apply to taxable years beginning after December 31, 1975.

Revenue effect

It is anticipated that this provision will produce a negligible loss of revenues.

5. Tax-Exempt Bonds for Student Loans (Sec. 2105 of the Act and sec. 103 of the Code)

Prior law

Under section 103(a) of the Code, interest paid on certain governmental obligations is exempt from Federal income tax. These obligations are those of the States and their political subdivisions, and of certain corporations organized under an Act of Congress as instrumentalities of the United States. However, interest on such governmental obligations (with a minor exception) is not exempt from taxation if a major portion of the proceeds can be reasonably expected to be used, directly or indirectly, to purchase nonexempt securities or obligations that can reasonably be expected to produce a higher yield over the term of the issue than the yield on the governmental obligations. These governmental obligations, which are subject to Federal taxation, are called "arbitrage bonds." In addition, governmental obligations whose proceeds are expected to be used to replace such nonexempt governmental obligations are themselves subject to tax.

However, governmental obligations are not treated as arbitrage bonds merely because their proceeds are temporarily invested in obligations paying a higher yield until those proceeds can be put to their intended purpose. In addition, obligations are not arbitrage bonds simply because their proceeds are invested in obligations paying a higher yield that are a part of a reasonably required reserve or replacement fund.

Reasons for change

Congress is aware that groups in at least one State are attempting to develop a student loan program for students desiring a college education. Since political subdivisions in the State apparently do not have the governmental authority to issue bonds to finance their own student loan programs, not-for-profit corporations in that State are being organized to finance the needed student loan programs. These corporations, however, faced considerable obstacles because the interest on bonds they wished to issue to finance student loans may have been taxable under prior law. The corporations are not political subdivisions of the State and could not be treated under the Treasury regulations as acting "on behalf of" the State or its political subdivisions. Even if they were described in section 103(a), these obligations might not have been exempt because they might have been arbitrage bonds under section 103(c).

Under the Emergency Insured Student Loan Act of 1969, the Commissioner of Education (of the Department of Health, Education, and Welfare) is authorized to provide incentive payments to institutions providing student loans. Although the maximum rate of interest to be paid by students on their loans is now set at seven percent, this yield, together with the incentive payments received by the institution making the loan from the Commissioner of Education, would constitute a yield that could be higher than the maximum yield the corporations believe they would be able to pay on their bonds if they are to cover administrative expenses and maintain a solvent loan program. Consequently, their bonds, under prior law, would be considered arbitrage bonds and not entitled to tax exemption.

Congress believes it is appropriate to treat the obligations of these corporations providing student loans in the same manner as if the State had issued the bonds directly.

Explanation of provision

This provision adds to the list of exempt obligations described in section 103(a) those obligations of not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes. The obligations are to be called "Qualified Scholarship Funding Bonds."

As a result of this provision, organizations which wish to maintain student loan programs will have statutory authority to issue tax-exempt bonds to finance their operations.

In addition, a provision is added to make it clear that the student loan incentive payments made by the Commissioner of Education under the Emergency Insured Student Loan Act of 1969 are not to be taken into account in determining whether the yield on the student loan notes is higher than the yield on the bonds issued to finance the student loan program. As a result, bonds issued to finance student loan programs would be expected to be able to avoid arbitrage bond classification.

Effective date

These provisions would apply to obligations issued on or after the date of enactment. Thus, the interest on bonds issued on or after the date of enactment in order to finance student loan programs to enable students to attend institutions of higher learning may be exempt from Federal taxation if the requirements of the amendment are met.

Revenue effect

It is estimated that these provisions will reduce the revenues by less than $5 million annually.

6. Personal Holding Company Amendments (Sec. 2106 of the Act and Sec. 543 of the Code)

Prior law

A corporation which is a personal holding company is taxed on its undistributed personal holding company income at a rate of 70 percent (sec. 541). A corporation is a personal holding company where five or fewer individuals own more than 50 percent in value of its outstanding stock and at least 60 percent of the corporation's adjusted ordinary gross income comes from certain types of income.

Royalties (other than mineral, oil or gas royalties and copyright royalties) received by a corporation are personal holding company income, regardless of how much income of other types the corporation may have (sec. 543(a)(1)). "Royalties" include amounts received for a license to use trade brands, secret processes, franchises and similar intangible property.

In general, rental income received from persons other than major shareholders is treated as personal holding company income unless such rent comprises 50 percent or more of the corporation's adjusted ordinary gross income and, if the company has a substantial amount of other types of personal holding company income, it distributes such income (sec. 543(a)(2)).

Under a separate rule of prior law (sec. 543(a)(6)), rents received by a corporation from leasing corporate "property" to a 25-percent or greater shareholder were personal holding company income, but only if over 10 percent of the company's total income came from other types of personal holding company income. In Rev. Rul. 71-596, 1971-2 Cum. Bull. 242, the IRS ruled that a company's income from licensing a major shareholder to make and sell a secret process was governed by the "royalty" rule rather than by the "shareholder rent" rule. In 1975 the U.S. Court of Claims also held in *Montgomery Coca-Cola Bottling Co.* v. *United States*, 75-1 USTC para. 9291, 35 AFTR 2d