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THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT
FROM: STU EIZENSTAT *Stu*
BOB GINSBURG
SUBJECT: Option Paper No. IX: Business Tax
Reductions

1. General Program.

- (a) Treasury and CEA have worked out a balanced set of proposals which include integration, a cut in the corporate tax rate, and investment tax credits (with the ITCs consisting of an extension of coverage of the present 10% ITC to industrial structures, etc. and a temporary 3-point increase in the ITC to 13%, phasing back down to 10% by 1982). The program amounts to \$6.6 billion at 1976 levels of income, as compared with approximately \$4 - \$5 billion of corporate tax preferences which our program will seek to eliminate. The \$6.6 billion figure does not, however, include the temporary increase in the ITC which would average about \$4 billion per year from 1979 through 1981.
- (b) The "balance" and inclusiveness of the program is both a virtue and a defect -- it may well be criticized by the business community as being a grab bag of relatively small items (a little integration, a little corporate rate cut, a little ITC, etc.) rather than significant focused expenditures. In addition, it has to be recognized that, unlike other parts of our tax reform program, each business proposal has good arguments against it as well as certain advantages.
- (c) While we support the general content of the Treasury-CEA program, in light of the comments by the business leaders at their meeting with you, you may wish to defer a final decision on this portion of the tax reform package pending a meeting with your advisers.

2. Partial Integration. Treasury has done a good job of setting out the pros and cons of each of the business tax proposals. We would, however, like to add some further discussion of partial integration.

The arguments in favor of partial integration (the shareholder dividend credit method) include:

- It will make good on your campaign statements in favor of the elimination of double taxation of dividends.
- Integration is favored by the business/financial community (particularly the financial community).
- An integration proposal would be well received by the stock market.
- An integration proposal may be of some help to us in our effort to eliminate the capital gains preference.
- Chairmen Ullman and Long favor an integration proposal and will probably be upset if we do not come up with one.
- Integration could encourage more equity (as opposed to debt) financing and lead to a desirable reduction in the debt/equity ratio for corporations.
- Integration could lead to a general improvement in the level of investor and business confidence which could feed back to increase capital formation.

The arguments against partial integration include:

- Integration will probably have little, if any, positive effect on capital formation, particularly over the next four to five years (reducing the general cost of capital could have some favorable effect over the longer run).
- Partial integration is complicated. It would represent a step back from our goal of greater simplicity.
- The business and financial community is probably willing to accept a limited expenditure now on partial integration in order to get a foot in the door and try to increase the amount of the dividend credit in the future. Any future increases in the dividend credit would be inherently biased in favor of upper income taxpayers.

- Under certain circumstances, the dividend credit can provide an actual tax refund for a person who has no income other than dividends while the average wage earner receiving the same amount of income will pay positive taxes.
- Most tax reformers (e.g., Joe Pechman, Stanley Surrey, etc.) regard partial integration as a step backward. They would make the argument that we will be spending about \$2-1/2 billion (at 1976 levels of income) and getting very little to show for it.

The Treasury proposal provides for a 25% "dividend credit" for shareholders ("grossing up" a 20% corporate withholding rate turns out to be a 25% increase in the after-tax rate of return for the shareholder). We have discussed this proposal with Reginald Jones of G.E. and other business leaders. While they prefer a 25% dividend credit, Mr. Jones indicated that a 20% credit would be satisfactory in their view. The lower credit could save up to \$600 million at 1976 income levels and greater amounts in later years. Because of the uncertain effects of integration, we recommend that you limit the dividend credit to 20%.

3. Corporate Rate Cuts vs. ITCs. The business leaders whom you met with today clearly prefer further cuts in the corporate tax rate over temporary increases in the ITC. (They did, however, appear sympathetic to an extension of the coverage of the present 10% ITC.)

I talked to Charlie and Mike after the meeting, and Charlie raised the important point that the advantage of the temporary increase in the ITC is that it is not a permanent tax reduction and, therefore, would have a reduced budget cost as it is phased out (however, Table 1 in the option paper indicates that even though the 3-point increase is phased down to 1 point by FY 1981, it still costs \$3.3 billion in that year).

There are a number of alternatives. For example, we might have a temporary increase in the ITC which would give the investment boost that Charlie wants and a reduction in the corporate rate timed to phase in when the temporary ITC is phasing out.

The message I got from the business leaders is that neither Congress nor they wanted a temporary increase in the ITC. My discussion with small business groups makes it clear that they are not particularly interested in ITCs either.



THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D. C. 20201

October 3, 1977

FOR THE PRESIDENT

FROM JOE CALIFANO *Joe Califano*

I have reviewed the summary of the tax reform proposal, which a member of my staff has been permitted to read in full. My comments are both substantive and strategic.

Substantive Comments

1. With respect to HEW, the issue of concern is the change in the medical expense deduction. My staff had opposed this change because they wanted to save the \$1.9 Billion in revenue loss for the National Health Insurance pot. That misses the issue from your point of view. You will undoubtedly be proposing that this be changed before it is ever enacted into law. The National Health Insurance proposal will reach the Congress sometime between March and June of next year and that proposal is almost certain to dramatically change the way the tax system now treats health.

I recommend that you drop this change in the medical expense deductions so that you do not suggest one thing in October or January, and another thing a few months later. In the alternative, I suggest that you explicitly indicate in the tax reform message that this particular provision will be subject to further evaluation in connection with National Health Insurance.

2. With respect to the tax reform/relief package as a whole, I see two problems: you are giving away too much money in the opening play, and you are compromising too much before the package leaves your desk. Everything

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October 3, 1977
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in tax reform is downhill from the moment the message is made public by the President. What you set in your tax reform message is the highest standard anyone can seriously hope for.

Your plan is a mixture of substantial tax relief with substantial tax reform. While I suppose every such plan has some element of relief and of reform, I cannot recall such heavy doses of each in a single package. In the current sluggish economy, I believe you leave yourself wide open to get plenty of relief and very little reform.

True

Strategic Comments

I think it may be political and tax reform suicide to send this package to the Congress now. Sending the Congressmen home with this package on the table will subject them to district pressures that will lead them to commitments to vote against certain aspects of the plan. Serving tax reform up now also puts yet additional cards in Russell Long's hands as he deals with you on Social Security, energy, hospital cost containment, and welfare reform. It gives Ullman a chance to detour the welfare reform hearings in the House.

One of the commonest complaints that I hear from the hill is that they are overloaded, and I must say that I myself feel some of that within this Department. The combination of hearings and mark-ups on hospital cost containment, welfare, Social Security, and Medicare/Medicaid fraud and abuse have made it extremely difficult to move some of that legislation out of the Ways and Means and Finance Committees. We have been unable, for example, to get a quorum in the Ways and Means Health Subcommittee on Hospital Cost Containment for the past two weeks because of other HEW bills in the full committee.

I recommend that you hold the package: ideally until early January (before Congress returns), or at least until late October when Congress recesses, so you can get the full benefit of the media in getting your program across.

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THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: STU EIZENSTAT *Stu*
BOB GINSBURG

SUBJECT: Tax Reform

Accompanying this memorandum are the following tax reform materials:

- (a) a one-page introductory memorandum from Mike Blumenthal, Stu Eizenstat, and Charlie Schultze;
- (b) an overview paper setting the reform proposals in their tax, budgetary, and economic context;
- (c) a summary of the Treasury option papers which you requested we prepare and which has been approved by CEA and Treasury;
- (d) the memoranda which you requested from Joe Pechman; and
- (e) a black notebook containing the nine option papers prepared by Treasury, each accompanied by our recommendations.

As you will see, there remain relatively few items of major significance on which we disagree with Treasury:

1. We do not think the Administration should propose any inflation adjustment for determining the amount of capital gains subject to tax. |
2. We think that a credible tax reform program requires a more vigorous effort against "expense account" living. |
3. We think the accumulated, untaxed DISC profits should be subject to tax in equal installments over a ten-year period. (This is a \$6 billion revenue item.) |
4. We think the deferral of tax for foreign subsidiaries should be eliminated. |

We have not developed a separate package of business tax reductions, although we do recommend a somewhat less expensive integration proposal than that contained in the Treasury-CEA program. However, in light of the rather strong indication from the business leaders at your meeting today that neither they nor Congress want any increase in the investment tax credit (as proposed by Treasury and CEA) and their indication that their primary desire is for corporate rate reductions, you may wish to defer final decision on the business tax section. After you left the meeting, Don Regan, Reg Jones, Walter Wriston and Tom Murphy indicated that they felt that rate reductions would have the greatest positive effect on investment. This bears further inquiry and Charlie should be heard on this.

I have become convinced that the tax reform program should not be presented until very late in the session, with Chairman Ullman being urged to hold hearings during the recess. |

Attachments

THE WHITE HOUSE

WASHINGTON

September 23, 1977

MEMORANDUM FOR: THE PRESIDENT

FROM: W. MICHAEL BLUMENTHAL
STUART EIZENSTAT
CHARLES SCHULTZE *CLS*

SUBJECT: Tax Reform Materials

*WMB
Stu*

Accompanying this memorandum are the following materials on tax reform:

1. An Overview of the tax reform program. This paper introduces the program and places it in a budgetary and economic context.
2. A Summary of the program's proposals. This paper briefly describes each proposal, indicating its revenue effect and which agencies endorse and oppose it.
3. Nine Option Papers. These papers analyze each proposal in depth, presenting for each:
 - the current law;
 - the proposed change;
 - the revenue effect of the change;
 - the advantages and disadvantages of the change;
 - the views of agencies concerned with the change; and
 - a space for you to indicate your decision.
4. Two Appendices. The first contains statistical data on the program and the second contains the full written views of affected agencies.

We have consulted extensively on the program and have reached agreement in most areas. Our remaining differences are noted in the Summary and more fully explained in the Option Papers. We have also consulted with the other interested agencies. Their written views are collected in the second Appendix, explained in the Option Papers, and (where major) noted in the Summary.

We recommend that you read the Overview and Summary before moving to the decision spaces in the Option Papers. We are of course ready at any time to meet with you or to supply further information.

September 15, 1977

MEMORANDUM TO THE PRESIDENT

FROM: Joseph A. Pechman
SUBJECT: The Tax Reform Program

The Treasury's proposals are a good basis for making presidential decisions on tax reform, but they need to be revised in a considerable number of important respects. In my opinion, the program should be more progressive and more responsive to the public (and the President's) demand for simplification. The proposed relief for dividends will complicate the tax law and will not promote capital formation. Finally, in too many instances, the Treasury has dropped or watered down tax reform proposals because of "industry opposition," "political" acceptability, or forecasts of what the tax committee's reaction will be. Compromises made at this stage will merely invite further watering down of the proposals in the tax legislative process.

Progressivity

14 → 70 to 12 → 50

The Treasury proposals would lower the average effective income tax rates in all income classes except for the very top class (\$200,000 and over), where they would be raised by an average of about 2 percentage points (from 35.1 percent to 37.0 percent). The top bracket rate on unearned income is reduced from 70 percent to 50 percent, while the first bracket rate is reduced from 14 to only 12 percent. It is true that the proposed \$250 per capita credit gives relatively large tax reductions in the bottom brackets, but still more can be done at these levels by revising the rate schedules. There is no reason why the breaking point at which the average tax burden will be raised should be as high as \$200,000.

An attempt should be made to reduce the first bracket rate to 10 percent. The revenue can be recovered by increasing higher bracket tax rates and by reducing the point where the 50-percent top rate begins from \$80,000 to \$60,000 for joint returns (and making corresponding revisions in the single person's schedule). A (10-50) percent schedule would be a much more dramatic (and saleable) basis for a tax reform program than the proposed 12-50 schedule.

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September 15, 1977

Simplification

The Treasury proposals still do not deliver on the President's promise to simplify the tax system for the average taxpayer. Although the number of itemizers is reduced, the tax return will remain formidable. However, the Treasury has rejected my idea of devising an alternate (lower) rate schedule for nonitemizers.

The major argument against the alternate rate schedule is that the lobbies for the itemized deductions (particularly charitable organizations and homeowners) will view it as a further erosion of the advantages of itemization and will oppose it strongly. However, this argument is weak because the proposal does not take anything away from the itemizers directly. The itemized deduction lobby has never been able to prevent increases in the standard deduction. Since the proposal is merely an extension of the idea of the standard deduction, it should be possible to withstand the pressure of the itemized deduction lobby.

The Business Tax Cut

The Treasury still relies on integration of the individual and corporation income taxes for a major portion of the business tax cut. In its present form, the integration proposal is merely dividend relief and will do very little to promote capital formation. (Even the most ardent advocates of integration concede that integration would not increase corporate investment.)

In addition, to avoid impairing the effectiveness of the investment credit and the foreign tax credit, the proposal envisages passing through to the shareholder the benefits of these provisions. This will introduce new complications for the shareholder and can hardly be regarded as consistent with the simplification objective.

I believe that the business tax cut should be limited to methods of stimulating investment directly--i.e., through investment credits and reductions in the corporate tax rate--rather than through the proposed dividend relief which will encourage higher dividend payouts and thus may reduce corporate saving. These methods are not only simpler, but are also more likely to promote the investment objective.

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As the business package now stands, Congress will be encouraged to proliferate additional "goodies" for business when it acts on the bill. It will be difficult to stop this in any event, but the Treasury-CEA package--a complex combination of different approaches--is an open invitation to Congress to do even more. It would be much better and more effective to keep the package simple.

Capital Gains

The boldest and most far-reaching part of the Treasury package is the proposal to tax capital gains as ordinary income, and to lower the tax rates to a maximum of 50 percent. In addition, capital gains transferred by gift or at death would be subject to tax. These changes would improve equity, simplify the tax law, and greatly diminish the time and effort now devoted to converting income into capital gains. While some investor groups will oppose full taxation of capital gains, I believe that most investors will welcome the simplicity and equity of the proposal. Cash salaries have become more attractive to corporate executives since 1969 when the maximum rate on earned income was reduced to 50 percent. Similarly, recipients of property income will find dividends, interest, and rents more attractive if the proposed rate cut is adopted.

While the basic proposal is sound, five of the detailed features of the proposal are questionable:

1. Gain attributable to the sale of residences with value up to \$75,000 would be exempt. No tax would be levied on capital gains on residences so long as the taxpayer moves from one house to another. There is no reason to exempt the gain on a residence if the taxpayer decides to give up this type of asset. If some exemption for residences is required, the amount should be greatly reduced. ?

2. Gain of up to a million dollars on the sale of venture capital stock held for more than ten years would continue to receive the equivalent of present law treatment. This is a sop to small business, but it is a pure giveaway and should be removed from the plan. ?

3. The basis of assets held for more than ten years would be adjusted for inflation. This is unwise because (a) long-held gains have benefitted from the interest on the tax

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postponed; (b) recipients of other property income with principal value that is eroded by inflation (for example, savings and loans deposits, fixed income securities, etc.) will be discriminated against and will rightfully demand similar treatment; and (c) the inflation adjustment will add substantial complexity to the law and thus defeat a major aim of the proposal. For all these reasons, the inflation adjustment for capital gains should be removed.

4. Pre-1977 capital gains would not be subject to the tax on capital gains transferred at death. However, it will produce an enormous lock-in effect, since investors with such gains would be taxable on them if they sold the assets but would be exempt if they hold the gains until death. While the proposal carries over the exemption of pre-1977 gains from the carry-over, it would be more equitable and economically sounder to push the date back at least a decade.

5. Capital gains transferred to charities (other than private foundations) would not be subject to tax. In previous drafts, the Treasury proposed taxing half these gains in order to keep the tax benefit at the level of present law. Why the Treasury believes the tax benefit should be enlarged is not indicated. | ?

Accelerated Depreciation for Multi-Family Housing

Accelerated depreciation for real estate is one of the devices available to high income individuals to avoid income tax. The Treasury proposes to limit depreciation on buildings to straight-line depreciation, but would permit 150 percent declining balance depreciation for new multi-family housing. Thus, a major source of tax shelters would be continued. Straight-line depreciation would be generous enough for such housing. If additional subsidies are needed, they should be provided directly through the HUD programs.

Depletion and Intangible Drilling Expenses

Under the Treasury plan, percentage depletion on all hard minerals would be phased out over a ten-year period. However, percentage depletion for small oil and gas producers

will be continued. This difference in treatment cannot be rationalized and will doubtless encourage Congress to continue percentage depletion for "small" minerals properties, thus complicating the law and watering down the equity of the proposal. It would be better to eliminate percentage depletion entirely after an appropriate phase-out.

Intangible drilling and development expenses would continue to be deductible, instead of being capitalized, but they would be included in the base of the minimum tax. This tax preference has been shown to be discriminatory and is not justified in light of the huge increase in oil prices. It should be removed, along with percentage depletion.

The Interest Deduction

The Treasury proposes to place a limit of \$10,000 on the deduction for personal interest payments. This would be separate from the limit of \$10,000 on the deduction for nonbusiness investment interest. The combined limit of \$20,000 is much too generous. It would be better to place one limit of \$10,000 on all interest payments that exceed the property incomes reported by the taxpayers.

Social Security and Veterans Benefits

The Treasury is opposed to the inclusion of social security and veterans benefits in the tax base. These exclusions are unjustified, particularly since the aged already receive generous treatment under the tax law. Such benefits should be subject to tax if other income exceeds \$10,000 for single persons and \$15,000 for married couples.

Travel and Entertainment Expenses

The Treasury recommends some tightening of the deductions for entertainment expenses, but the proposed treatment is excessively lenient. In addition to the proposed disallowance of deductions for yachts, hunting lodges and club dues, the law should be amended to (a) place a flat dollar limit per person per meal on deductions for business meals; (b) eliminate the deduction for tickets to sporting events, theatres, etc.; and (c) limit the deduction for air travel to the equivalent of coach fare. There will be cries of anguish from the restaurant industries, the airlines, and business in general, but there is no reason why high living of business executives should be financed by the taxpayer.

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Interest on Life Insurance Policies

A major omission from the tax base is the interest earned on the savings element of life insurance policies, yet the Treasury does not favor taxing such interest "because of the probable strength of industry opposition." This type of interest is no more deserving of exemption than any other interest received by taxpayers. If interest on life insurance policies remains tax exempt, life insurance will continue to have a competitive advantage relative to other forms of saving. Such differential treatment is not justified on equity or economic grounds.

Taxable Bond Option

The Treasury recommends that the taxable bond option for states and local governments be made available for "small" issues of industrial development bonds. The tax exemption for industrial development bonds has created numerous abuses, and there is no reason for the federal government to subsidize even small issues of such bonds.

Recapture of DISC Deferrals

The DISC provision would be eliminated under the Treasury proposal, but previously deferred income would not be taxed until it is returned to the parent company. This amounts to an indefinite tax exemption, under a provision which was intended to defer, and not to exempt, taxes on export income. If DISC is eliminated, profits previously put into tax-free DISCs should be included in the tax base over a period of no more than ten years.

Deferral of Tax on Income of Foreign Corporations

The Treasury continues to oppose the taxation of income of U.S. controlled corporations currently, despite the fact that the provision provides an incentive for corporations to invest abroad and to manipulate their accounts so as to avoid tax on a large proportion of their foreign income. The President's campaign promise to eliminate this preferential treatment should be kept.

September 15, 1977

MEMORANDUM TO THE PRESIDENT

FROM: Joseph A. Pechman
SUBJECT: Further Views on Integration

I still believe that it would be unwise to propose any form of integration of the corporation and individual income taxes to the Congress. Despite all the work done by the Treasury, the dividend relief which is now proposed remains complicated and will not promote the objective of stimulating capital formation. In my opinion, equity and economic objectives will be served better by using the revenue to reduce the corporate tax rate further.

The following are comments on the arguments presented by the Treasury in favor of the proposed dividend relief (Tax Reform Option Paper No. IX, pp. 6-7):

1. It is true that dividend relief will increase the attractiveness of equity financing. However, the real question is whether it will increase investment, and on this point even the most ardent proponents of integration admit that the investment effect is nil. In fact, if the proposal stimulates higher dividend payments, the likelihood is that total investment will be reduced because corporations will invest more of a dollar of retained earnings than the amount that shareholders will invest out of the increased dividend payment.

2. Even though dividend relief is progressive among shareholders, it is regressive because there are so few shareholders in the bottom brackets. As the Treasury indicates, any corporate tax cut is regressive and the difference between dividend relief and corporate rate cuts in this respect is small.

3. The allegation that the present system of taxation discourages the use of the corporate form of doing business is simply not consistent with the facts. Despite the fact that the corporate tax rate has quadrupled since 1929, the proportion of the total business of the country generated by corporations has increased from 56 percent to about 71 percent.

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4. There is no reason to expect that dividend relief will increase saving and investment any more than any other tax cut on business and property income. In fact, as Charles Schultze has pointed out, direct tax incentives (through investment credits and higher depreciation allowances) are much more likely to increase investment.

5. The effect of the plan on dividend payouts is uncertain. But it is clear that dividend relief will not reduce payouts, hence the plan cannot increase corporate saving.

In addition to the arguments against the proposal listed on page 7 of the Treasury option paper, consideration should be given to the following points:

1. A reduction in the corporate tax rate will reduce the burden of the corporate tax not only on dividends, but also on retained earnings. It, therefore, accomplishes part of the objective of the dividend relief plan (reduced taxation of dividends) without unduly complicating the tax law. It cannot be emphasized too strongly that the proposed dividend relief will introduce new complications and is surely a long step away from tax simplification. (I have just returned from a trip to Europe, where I discussed the movement toward integration among EEC countries with tax officials. Many of these officials now regret the adoption of their own dividend relief proposals, precisely because they find it very complicated for corporations, individuals, and the government.)

2. Tax-exempt organizations will not be eligible for dividend relief, but there is no indication in the Treasury memorandum why this decision is made. Such organizations will rightfully argue that they should be treated as zero-rate taxpayers, and therefore should be eligible for the dividend relief. If they are persuasive, the revenue loss of the proposal will increase.

3. If adopted, the dividend relief plan is really a dead end so far as future tax policy is concerned. It will always be criticized as being regressive, and will be the continuous target of tax reformers. Future administrations are hardly likely to propose additional dividend relief, since any increase in the credit will be regressive. Thus, the new dividend relief plan will probably suffer the fate of the dividend credit enacted in 1954--which started out as a proposed 15 percent credit, was then reduced to 4 percent by Congress, and ultimately dropped in 1964 after a decade of criticism).

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4. The strongest supporters of dividend relief are the members of the financial community. They stand to gain because they view the proposal as a method of increasing the number of stock issues; it is, therefore, clearly to their advantage. Business managers in industry are, however, concerned that dividend relief will increase the pressure for higher payouts. With the amount of relief now cut down to 20 percentage points of the corporate tax, they are likely to support the proposal mainly because it will reduce their own taxes and in the expectation that they can withstand the pressure for higher dividend payouts. From the standpoint of national needs, however, the \$2.5-billion cost of the proposal can be used much more effectively to promote investment by alternative routes.

For all these reasons, I believe that it would be a mistake to incorporate the proposed dividend relief plan in the administration's tax reform package.

EXCERPTED COMMENTS ON TAX REFORM

Reginald H. Jones
Chairman and Chief Executive Officer
General Electric Company
September 23, 1977

Mr. President, we appreciate this opportunity to present some thoughts developed by The Business Roundtable on the subject of tax reform.

We view your upcoming message on proposed tax legislation as a unique opportunity to improve business confidence, increase investment spending, and spur a somewhat hesitant economy. While leading indicators have dropped, we still believe that the U.S. economy has considerable vitality. But we are concerned that business investment continues to lag historic and needed levels, and this is the vital ingredient to continued economic growth and enhanced employment. Your message on tax reform could be the signal that will dispel much of the uncertainty that currently plagues businessmen.

We endorse the thinking of the Administration that tax cuts for individuals should be granted in the range of \$10-\$15 billion. Such action is needed to offset the effects of inflation under our progressive rate structure.

It is our understanding that the Administration proposes tax relief for business on the order of \$5-\$7 billion. If this amount could be truly classified as tax cuts for business, it would be

of a magnitude that could achieve the desired results. But it should be pointed out that \$4-\$5 billion of this total is allocated to partial integration (which we support) and that these dollars are passed through directly to individual investors and are not retained by business for investment. It is our conviction that an increase in the tax relief accorded directly to business would be a good investment and would not damage the Administration's desires to follow sound fiscal policies looking toward a reduction of government deficits. We are mindful that in the 30-year period from 1946 to 1976 there have been ten tax reductions for individuals. In all cases but one (the 1948 reduction) tax revenues have risen to new highs with only a one-year hiatus.

For the period 1960-1973, among the seven principal industrialized countries of the world, the United States ranked last in business fixed investment as a percent of real national output, last in productivity growth, and next to last in output growth. Other Government studies have indicated that 12% of real GNP must be devoted to business investment during the period to 1980 to reduce unemployment to 5%. Yet during the last two years, such investment averaged only 9.3% of GNP.

We believe that investment has lagged because the real return on investment (adjusted for inflation) has declined from 9.9% in 1965 to 4.0% in 1976.

The most effective way to improve business results is through a meaningful and permanent cut in the corporate tax rate. This affects all business whether labor or capital intensive. Specific

investment incentives are also useful; but because they introduce inequities, they are not as widely accepted by the total business community.

Still, we see the need for certain changes in investment incentives. Among such incentives, we do favor shorter capital recovery periods and immediate write-off of pollution control expenditures. The investment tax credit should be extended to buildings, and the allowable amount increased beyond the present 50% of tax liability. There has been much discussion of an increase in ITC percentage above 10%. Our discussions with Congress lead us to the conclusion that greater support could be realized for the changes in the implementation of ITC just outlined and other forms of tax relief. We should like to point out that substantial investment expenditures will be required of the mining industry in the years ahead. Reduction of percentage depletion allowances would be most untimely if the needed funds are to be available.

Most businesses have never known a time when international competition was more intense. Foreign competitors, aided by their governments, seek to export their own unemployment and strengthen their balance of payments position. U.S. businesses need the support of their Government to expand our international trade and increase our employment.

The two international tax issues of concern to business are the rumors that the Administration may propose the current taxation of undistributed income of controlled foreign subsidiaries and the repeal of DISC. We regard the former as anticipatory

taxation -- taxation of income that may never be realized by the taxpayer. It would subject U.S. business to tax treatment used by no other nation in the world and severely handicap U.S. business in its competitive struggle around the world. Treasury studies have shown that U.S. taxation of such undistributed earnings would benefit principally foreign treasuries, since they resort to withholding taxes on dividend distributions.

DISC tax deferrals have been one of the factors in the increase in U.S. exports from \$43 billion in 1971 to \$115 billion in 1976. In the face of our current trade deficits and the ongoing GATT negotiations, it would be most untimely to discontinue DISC. It provides tax benefits that are only a fraction of those accorded by many governments to their exporters through the rebate of value-added taxes.

It is apparent that the Administration regards the issues of capital gains, integration and individual rate reduction as a package. We understand that it is central to the Administration's thinking that essentially all income, regardless of source, should be taxed at uniform rates. As an offset, relief would be provided through partial integration and an overall reduction in individual rates. Looking at this total package, we suggest the following relatively inexpensive modifications:

- Capital gains on assets held for long periods should be taxed at gradually reduced rates, related to the holding period, recognizing that gains due to inflation are not real gains.

- There should be a rollover provision for a limited time period to defer the taxation of capital gains if the proceeds are reinvested. This will unlock frozen investments that carry large gains and enhance the mobility of capital at a time when it is really needed.

If capital gains are to be taxed as ordinary income, the double taxation of dividends should be reduced substantially. Business supports integration only if it can be obtained without trade-offs of capital formation incentives of proven value. This could be accomplished by a gradual phase-in, which would also be less disruptive of the securities markets. A dividend gross-up and a 20% fixed rate tax credit for shareholders would put more funds in the hands of shareholders, increase the attractiveness of equity securities, and stimulate the issuance of new equity.

If capital gains are to be taxed as ordinary income, a meaningful rate reduction, together with reduced taxation of dividend income under integration, would help temper the effect of that change on individual investors. There is strong support for an across-the-board reduction in all individual income tax rates, with the top rate being set no higher than 50%. Such a reduction would give all individuals added incentive to work and invest and should contribute significantly to the achievement of the economic objectives of tax reform.

Mr. President, the capital formation problem is a long-term problem, and the solution requires a basic tax reduction that encourages a high, sustained level of business investment.

Therefore, we hope your Administration will avoid the temptation to "hypo" the economy with temporary and selective incentives.

The tax reform package can be the touchstone to dispel much of the gloom on Wall Street. It can be the signal that your Administration understands and is supportive of the business community. It presents a rare opportunity that can have lasting significance.

COMMENTS ON TAX REFORM

Reginald H. Jones
Chairman and Chief Executive Officer
General Electric Company
September 23, 1977

Mr. President, we appreciate this opportunity to present some thoughts developed by The Business Roundtable on the subject of tax reform.

We view your upcoming message on proposed tax legislation as an event of great significance and a unique opportunity to improve business confidence, increase investment spending, and spur a somewhat hesitant economy. Leading indicators have dropped for three months in a row, industrial production slipped slightly in August and Wall Street continues to give troubled portents. Importantly, the recovery has stalled in Europe and Japan and mercantilist policies threaten international cooperation. While we still believe that the U.S. economy has considerable vitality, we are concerned that business investment continues to lag historic and needed levels, and this is the vital ingredient to continued economic growth and enhanced employment. Thus your message on tax reform takes on added importance. It could be the signal that will dispel much of the uncertainty that currently plagues businessmen. Their confidence has been shaken by deep recession, chronic inflation, credit crunches, sharp erosion of the real return on investment, and a plethora of confusing and costly regulations.

Magnitude of Tax Relief

We endorse the thinking of the Administration that tax cuts for individuals should be granted in the range of \$10-\$15 billion. Such action is needed to offset the effects of inflation under our progressive rate structure. The resultant increases in personal disposable income will help to sustain consumer buying and thus support the economy and overall business activity.

It is our understanding that the Administration proposes tax relief for business on the order of \$5-\$7 billion. If this amount could be truly classified as tax cuts for business, it would be of a magnitude that could achieve the desired results. But it should be pointed out that \$4-\$5 billion of this total is allocated to partial integration (which we support) and that these dollars are passed through directly to individual investors and

are not retained by business for investment. It is our conviction that an increase in the tax relief accorded directly to business would be a good investment and would not damage the Administration's desires to follow sound fiscal policies looking toward a reduction of government deficits. We are mindful that in the 30-year period from 1946 to 1976 there have been ten tax reductions for individuals. In all cases but one (the 1948 reduction) tax revenues have risen to new highs with only a one-year hiatus. Although it is difficult to project the secondary impacts of tax cuts, history would indicate that the longer range results benefit tax revenues.

Capital Formation - Investment Incentives

A 1975 U.S. Treasury study showed that, for the period 1960-1973, among the seven principal industrialized countries of the world, the United States ranked last in business fixed investment as a percent of real national output, last in productivity growth, and next to last in output growth. Other Government studies have indicated that 12% of real GNP must be devoted to business investment during the period to 1980 to reduce unemployment to 5%. Yet during the last two years, such investment averaged only 9.3% of GNP.

We believe that investment has lagged because the real return on investment (adjusted for inflation) has declined from 7.3% in 1955 and 9.9% in 1965 to 4.0% in 1976. The burden of Federal income taxes on corporations increased somewhat faster than that on individuals from 1966 to 1976. The effective tax rate on corporate income (adjusted for inflation) rose from 38.1% in 1966 to 43.6% in 1976 -- a 14% increase. Meanwhile, the effective tax rate on individual income (also adjusted for inflation) rose from 10.5% in 1966 to 11.4% in 1976 -- a 9% increase.

The most effective way to improve business results is through a meaningful and permanent cut in the corporate tax rate. This affects all business whether labor or capital intensive. Specific investment incentives are also useful; but because they introduce inequities, they are not as widely recognized and accepted by the total business community as the effective spur to business confidence. Still, we see the need for certain changes in investment incentives at this particular juncture. Among such incentives, we do favor shorter capital recovery periods and immediate write-off of pollution control expenditures. The investment tax credit is most helpful, should be applied to buildings as well as equipment, and the allowable amount should be increased beyond the present 50% of tax liability. There has been much discussion of an increase in ITC percentage above 10%. Our discussions with

Congress lead us to the conclusion that greater support could be realized for the changes in the implementation of ITC just outlined and other forms of tax relief. We should like to point out that substantial investment expenditures will be required of the mining industry in the years ahead. Reduction of percentage depletion allowances would be most untimely if the needed funds are to be available.

International Tax Issues

Most businesses have never known a time when international competition was more intense. Foreign competitors, aided by their governments, seek to export their own unemployment and strengthen their balance of payments position. We have previously referred to the growing trends of protectionism and mercantilism. U.S. businesses need the support of their Government to expand our international trade and increase our employment. We estimate that there are currently 7 600 000 jobs in the U.S. related to international business and that, while our imports have produced a loss of some 3 000 000 jobs, the balance of employment is still strongly in favor of increased international activity.

The two international tax issues of concern to business are the rumors that the Administration may propose the current taxation of undistributed income of controlled foreign subsidiaries and the repeal of DISC. We regard the former as anticipatory taxation -- taxation of income that may never be realized by the taxpayer. It would subject U.S. business to tax treatment used by no other nation in the world and severely handicap U.S. business in its competitive struggle around the world. Foreign subsidiaries are established not as an alternative to domestic investment but as a supplement to such investment. They give us a position in markets otherwise closed to the U.S. Less than 10% of total sales of such U.S. subsidiaries find their way back into the U.S. and half of that total represents imports from Canada under the automotive pact. Yet, they provide a huge outlet for our exports as between 20%-30% of U.S. exports are made to them. Treasury studies have shown that U.S. taxation of such undistributed earnings would produce little revenue. The increased tax burden would benefit principally foreign treasuries, since they resort to withholding taxes on dividend distributions.

DISC tax deferrals have been one of the factors in the increase in U.S. exports from \$43 billion in 1971 to \$115 billion in 1976. While it is true that there have been other factors influencing this growth, there can be no argument that DISC has been of assistance in financing the longer term foreign receivables and in enhancing offshore market development. In the face of our current trade deficits and the ongoing GATT negotiations, it would

be most untimely to discontinue DISC. It provides tax benefits that are only a fraction of those accorded by many governments to their exporters through the rebate of value-added taxes.

Capital Gains, Partial Integration, and Individual Rate Reduction

It is apparent that the Administration regards these three issues as a package.

The businessman looks to the effect of these changes on long-term growth of the economy and opportunities for increased employment.

- Will they increase corporate retained earnings, and thus stimulate capital investment?
- Will they increase the willingness of corporations to issue new equity instead of debt?
- Will they spark a renewed interest of the individual investor in the stock markets and thus facilitate equity financing?

Ideally, if we are to move in the direction of achieving the objectives listed above, the tax burden on capital should be reduced, rather than increased. The present tax laws, which tax (1) the income which is the source of capital, (2) the income produced by capital, and (3) the gains from the sale of capital assets, contain a strong bias against accumulation and efficient deployment of capital.

Yet we understand that it is central to the Administration's thinking that essentially all income, regardless of source, should be taxed at uniform rates. As an offset, relief would be provided through partial integration and an overall reduction in individual rates. Looking at this total package, we suggest the following relatively inexpensive modifications:

- Capital gains on assets held for long periods should be taxed at gradually reduced rates, related to the holding period, recognizing that gains due to inflation are not real gains.

- There should be a rollover provision for a limited time period to defer the taxation of capital gains if the proceeds are reinvested. This will unlock frozen investments that carry large gains and enhance the mobility of capital at a time when it is really needed.

These modifications would reduce the adverse impact of ordinary income taxation of capital gains and allow time for adjustment as partial integration is phased in over a somewhat comparable period of years.

Particularly if capital gains are to be taxed as ordinary income, the double taxation of dividends should be reduced substantially. This would:

- Encourage issuance and purchase of equity securities.
- Improve the balance of corporate capital structures.
- Give a much needed stimulus to the securities markets.

Business supports integration only if it can be obtained without trade-offs of capital formation incentives of proven value. This could be accomplished by a gradual phase-in, which would also be less disruptive of the securities markets.

A dividend deduction for corporations would initially improve corporate cash flow and retained earnings, and would thereby directly benefit capital formation. Long-range, however, it might encourage excessive dividend payouts at the expense of retained earnings.

A dividend gross-up and tax credit for shareholders would put more funds in the hands of shareholders, increase the attractiveness of equity securities, and stimulate the issuance of new equity. If this method is adopted:

- The tax credit should be at a fixed rate -- the suggested withholding rate of 20% (gross-up rate of 25%) should be acceptable.
- The objective should be to work toward a higher rate.
- Increases in the rate should be timed to coincide with increases in the taxation of capital gains, if the latter are enacted.

Proposals to require additional tax payments by a corporation if tax credits to its shareholders exceed its regular corporate income tax should be approached with caution. Such a requirement could cancel out tax benefits presently in place to aid capital formation. At a minimum, the amount of the regular corporate income tax, for this purpose, should be before reduction for the investment credit and at least half of the foreign tax credit. It is strongly recommended that other corporate tax preferences also be given consideration in this calculation. We concur with the thinking that corporate tax payments unused in the calculation of amounts available to cover withholdings on dividends be carried forward to future years.

There is a strong need to reduce individual income tax rates to offset a significant part of the unlegislated tax increase which has been caused by inflation.

Further, if capital gains are to be taxed as ordinary income, a meaningful rate reduction, together with reduced taxation of dividend income under integration, would help temper the effect of that change on individual investors.

There is strong support for an across-the-board reduction in all individual income tax rates, with the top rate being set no higher than 50%. Such a reduction would give all individuals added incentive to work and invest and should contribute significantly to the achievement of the economic objectives of tax reform.

Conclusion

The capital formation problem is a long-term problem, and the solution requires a basic tax reduction that encourages a high, sustained level of business investment. Therefore, we hope the Administration will avoid the temptation to "hypo" the economy with temporary and selective incentives. We are dealing more with a structural problem than we are with a cyclical situation that calls for transient contra-cyclical fixes.

The tax reform package can be the touchstone to dispel much of the gloom on Wall Street. It can be the signal that the Administration understands and is supportive of the business community. It presents a rare opportunity that can have lasting significance.

CAPITAL GAINS, INTEGRATION, AND INDIVIDUAL RATE REDUCTION

Three key elements of the tax reform proposals being considered are ordinary income taxation of capital gains, partial integration of corporate and individual income taxes, and across-the-board reduction of individual income tax rates.

The businessman looks to the effect of these changes on long-term growth of the economy and opportunities for increased employment.

- Will they increase corporate retained earnings, and thus stimulate capital investment?
- Will they increase the willingness of corporations to issue new equity instead of debt?
- Will they spark a renewed interest of the individual investor in the stock markets and thus facilitate equity financing?

Taxation of Capital Gains

Ideally, if we are to move in the direction of achieving the objectives listed above, the tax burden on capital should be reduced, rather than increased. The present tax laws, which tax (1) the income which is the source of capital, (2) the income produced by capital, and (3) the gains from the sale of capital assets, contain a strong bias against accumulation and efficient deployment of capital.

Yet we understand that it is central to the Administration's thinking that essentially all income, regardless of source, should be taxed at uniform rates. As an offset, relief would be provided through partial integration and an overall reduction in individual rates. Looking at this total package, we suggest the following relatively inexpensive modifications:

- Capital gains on assets held for long periods should be taxed at gradually reduced rates, related to the holding period, recognizing that gains due to inflation are not real gains.
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These modifications would reduce the adverse impact of ordinary income taxation of capital gains and allow time for adjustment as partial integration is phased in over a somewhat comparable period of years.

Partial Integration of Corporate and Individual Income Taxes

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- The tax credit should be at a fixed rate -- the suggested withholding rate of 20% (gross-up rate of 25%) should be acceptable.
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Reduction in Individual Income Tax Rates

There is a strong need to reduce individual income tax rates to offset a significant part of the unlegislated tax increase which has been caused by inflation.

Further, if capital gains are to be taxed as ordinary income, a meaningful rate reduction, together with reduced taxation of dividend income under integration, would help temper the effect of that change on individual investors.

There is strong support for an across-the-board reduction in all individual income tax rates, with the top rate being set no higher than 50%. Such a reduction would give all individuals added incentive to work and invest and should contribute significantly to the achievement of the economic objectives of tax reform.

INTERNATIONAL TAX ISSUES

There is a need for tax policies which will increase U.S. exports and permit U.S. businesses to be competitive worldwide.

- U.S. exports create U.S. jobs.
- U.S. balance of trade deficit in 1977 is expected to approximate \$25 billion due to higher value of oil imports and sluggishness in growth of U.S. export sales. Substantial deficit is also forecast for 1978.
- Foreign investments contribute to increased export sales.
- Income from foreign investments has a favorable impact on the U.S. payments position.

Current Taxation of Undistributed Income of Controlled Foreign Corporations

- Would result in anticipatory taxation - taxation of income which may never be realized by the taxpayer. Contrary to underlying principle that taxes are levied on realized income.
- U.S. businesses go abroad to take advantage of market opportunities which would otherwise be taken by foreign competitors because of competitive conditions or lack of free choice as to source of manufacture to serve world-wide markets.
 - Foreign investment is undertaken not as an alternative to domestic investment but to supplement such investment.
 - Less than 10% of total sales of U.S. subsidiaries abroad are imported to the U.S. of which almost half represents imports from Canada under the automotive pact.
 - Foreign investments provide substantial benefits to the U.S. economy from export sales which otherwise would not be made except for these foreign investments. Between 20%-30% of U.S. exports are made to foreign affiliates of U.S. corporations.

- Foreign investments contribute positively to the U.S. balance of payments.
 - Income from direct investments exceeded outflows by \$5 billion in 1975, even after excluding the income from oil investments.
- Current taxation would adversely affect the competitive position of U.S. subsidiaries by subjecting their earnings to a tax burden higher than their foreign based, foreign owned competitors.
 - Result would be loss of market position, reduction in U.S. exports, gradual liquidation of foreign investments, and unfavorable effect on the balance of payments.
 - Increased tax burden would benefit principally foreign treasuries, since they resort to withholding taxes on dividend distributions.
 - Any adverse effect on cash liquidity of U.S. parent corporations would reduce U.S. funds for job creating investment in U.S. facilities and U.S. research and development.
 - Major impact would be on investments in less developed countries where generally lower tax rates prevail and which offer the greatest potential for increased U.S. exports as well as providing sources of supply of many necessary raw materials.
- So-called "deferral" should be retained to permit U.S. businesses to remain competitive in world-wide markets vis-a-vis foreign owned, foreign based competitors and to avoid otherwise adverse effects on the overall U.S. economy.

DISC

- DISC was enacted to encourage U.S. exports.
- DISC benefits have been far less than export benefits realized by foreign competitors under tax policies of their governments, particularly rebates of value added taxes.
- Since DISC was enacted there has been tremendous growth in U.S. exports from \$43 billion in 1971 to \$115 billion in 1976 as a result of floating dollar, higher world trade levels and DISC. This tax deferral from DISC has been a factor in providing cash funds to:

- Finance export related receivables to meet financing terms of foreign competitors.
- Underwrite market development programs for U.S. exports which otherwise would not have been undertaken because of budgetary or other financial restraints.
- EEC protest of DISC clearly indicates that foreign governments view DISC as a positive stimulant to U.S. exports.
- It is essential to retain DISC and continued deferral of accumulated DISC tax benefits:
 - To further encourage expansion of U.S. exports to sustain domestic economic growth. It has been estimated that each \$1 billion of exports creates 70,000 additional domestic jobs.
 - To help maintain the competitive position of U.S. business in world markets.
 - To improve U.S. balance of trade.
 - To strengthen U.S. bargaining position in GATT negotiations.

CAPITAL FORMATION
INVESTMENT INCENTIVES

The United States must increase the share of its resources devoted to capital investment to achieve sustained economic growth, increase productivity and real wages, reduce inflation and provide jobs for a growing labor force. Higher levels of capital investment are also required to build a tax base for future social services and to meet national needs with respect to energy, the environment, housing and the rebuilding of the cities.

Need for Action

- U.S. private investment and economic and productivity growth rates lag (1975 study by U.S. Treasury). Among the seven principal industrialized countries of the world the United States ranked last in business fixed investment as a percent of real national output, last in productivity growth and next to last in output growth.
- Declining rate of investment in plant and equipment is slowing down growth in productivity and real wages.
 - Growth rate in the amount of private plant and equipment (excluding pollution control expenditures) declined from 4.3% per year in 1965-70 to 3.3% per year in 1970-75 and can be expected to decline further to 2.5% per year in 1975-77.
 - Growth rate of plant and equipment per worker fell from 2.6% in 1965-70 to 1.6% in 1970-75 and is expected to decline to 1.0% in 1975-77.
 - Productivity growth rate fell from 2.4% in 1965-70 to 1.0% in 1970-75.
 - Since 1969, real hourly wages have grown by less than 1% a year.
- Additional investment needed to create jobs.
 - Civilian labor force is expected to rise from 93 million in 1975 to 103 million in 1980 and to 110 million in 1985; an average annual increase of 1.5 million workers.

- Commerce Department study (1975) indicates that 12% of real GNP must be devoted to business investment during 1975-80 to reduce unemployment to 5% and to meet energy and environmental needs; however, between 1965 and 1974 business investment averaged only 10.4% of GNP, during 1975 and 1976 it averaged only 9.3%.
- Capital spending and private sector employment are closely correlated; argument that investment in labor-saving devices reduces employment is not borne out by experience.
- U.S. will run out of plant capacity before it runs out of unemployment; unemployment rates when economy runs at "full capacity:" 3.4% in 1968, 4.8% in 1973, 6.0% or more expected in 1978.
- Incentives and means for investment have eroded.
 - Reported profits of nonfinancial corporations, after taxes, have increased 107% since 1965; however, when adjusted for inflation (under-depreciation and phantom inventory profits) they have increased only 21%. During the same period, undistributed profits (adjusted for inflation) actually declined 42%.
 - Real return on investment (adjusted for inflation) has declined from 7.3% in 1955 and 9.9% in 1965 to 4.0% in 1976.
- The burden of Federal income taxes on corporations increased slightly faster than that of individuals between 1966 and 1976.
 - Effective tax rate on corporate income (adjusted for inflation) rose from 38.1% in 1966 to 43.6% in 1976 - a 14% increase.
 - Effective tax rate on individual income (adjusted for inflation) rose from 10.5% in 1966 to 11.4% in 1976 - a 9% increase.

Action Required

While other governmental policies affect the climate for investment, the most direct way to stimulate higher levels of capital investment is to provide through productive reform of the tax system greater incentives for capital formation such as:

- A substantial and permanent cut in the corporate tax rate.
- Shorter capital recovery periods for property.
- Immediate write-off of pollution control expenditures.
- Making the investment tax credit permanent.
- Making the investment tax credit applicable to expenditures as incurred and making it applicable to expenditures mandated by legislation or regulation, and also applicable to buildings.
- Increasing the investment tax credit rate but only if other aspects of tax reform do not produce the needed increases in capital formation. Increasing the rate is not viewed as being of the highest priority nor as being attractive to Congress. *maybe*
- Increasing the allowable investment tax credit from 50% to 90% or 100% of tax liability.
- Retaining percentage depletion on hard minerals.

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U. S. DEPARTMENT OF LABOR

OFFICE OF THE SECRETARY

WASHINGTON

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for Preservation Purposes**

MEMORANDUM FOR: THE PRESIDENT

FROM: SECRETARY OF LABOR *Rory*

SUBJECT: Tax Reform Proposals

I recognize that the tax reform proposals are moving expeditiously toward final decisions. The Treasury tax reform package which is now before you does include an August 18 memorandum from me to Secretary Blumenthal. Since then, I have learned more about the dimensions of the Treasury proposals and while I agree strongly with their major direction, I want to provide you with my recommendations regarding three specific points that still remain unresolved.

Integration of Tax Proposals with Administration's
Economic Goals

My first concern relates to the overall size and timing of the tax reduction. In my view, it is crucial that the timing and the size of the tax reduction place the economy on a firm growth path that will bring the unemployment rate below 5 percent by the second half of 1980.

The joint CEA, Treasury, OMB, Commerce and Labor economic forecast now shows that without added fiscal stimulus, the economy begins to stagnate in 1978 with the unemployment rate leveling off at 6½ percent in 1979. To bring the unemployment rate down to about 5 percent by 1980, the economy must grow in the 5½ to 6 percent range--or about 2¼ percentage points above the 3½ percent rate forecast under the assumption of no fiscal stimulus.

Given a 1978 nominal GNP level of about \$2100 billion, this added 2¼ percent growth rate calls for an additional \$47 billion in GNP. Assuming a tax "multiplier" of 2, this points to a tax reduction in the area of \$23 billion. *#2-T*

The current proposal calls for a tax reduction of about \$16 billion in FY 1979 and increasing thereafter. In view of the economic forecast, these reductions are too small and too late. It implies that a "crash" tax reduction effort will be required in 1979 or 1980. This can be avoided now by providing for more adequate fiscal stimulus in the current tax package.

Rate Structure for the Individual Income Tax

One of the initial Labor Department criticisms of the tax proposal was a lack of progressivity in the proposed rate structure along a broad middle section of the income distribution which accounts for most of tax collections. This difficulty is accentuated by the proposed reduction in the top bracket rate from 70 percent to 50 percent, since this is associated with a relatively heavy reduction in tax liability for the higher income groups.

The current proposal, only slightly more progressive than the initial one, incorporates a range of tax rates from 12 percent to 50 percent, with a phase-in of the 50 percent rate delayed until the \$80,000 level for a joint return. Comment in the tax reform package indicates that the Domestic Policy Staff supports a rate schedule which runs from 10 percent to 50 percent with an earlier phase-in of the maximum rate at \$60,000 for a joint return rather than \$80,000. This proposal has two advantages: (1) the lower initial rate provides further reductions among the lowest income groups and (2) the earlier phase-in of the 50 percent rate cuts back the quite substantial tax reductions for those in the upper income bracket. The loss in revenue from these two aspects of the proposal is offset by small rate increases throughout much of the tax structure. I strongly support this DPS alternative.

*10-50
50% at
\$60,000*

Deferral of Tax on Income Earned Abroad

The Treasury does not recommend repeal of deferral although it is discussed as a possibility. DOL has supported the repeal of deferral as well as DISC. Furthermore, a repeal of deferral is particularly important given the proposed repeal of DISC since DISC export subsidy provisions may have offset some of the incentive for firms to locate abroad provided by deferral.

The major proponents of retaining deferral have been the multinational corporations. The major opponents have been labor unions, and their position is generally

supported by academic economists. In the paper which summarizes the entire tax package, the Treasury reports that the Commerce and State Departments oppose the repeal of deferral. However, they did not note that the Labor Department supports repeal. I want to make clear my full support for repeal of the deferral provision.

AGENCY COMMENTS

APPENDIX
AGENCY COMMENTS



DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

AUG 25 1977

SUBJECT: Proposed Tax Revisions

TO: Laurence Woodworth, Assistant Secretary
Department of Treasury

This memorandum is an informal response to the proposed tax revisions you outlined last evening to members of my staff. The short response period limits us to a brief statement of the Department's interests and concerns. Secretary Bergland, who is out of town this week, has a keen interest in the proposed revisions and their potential impacts on the food system and may wish to send a more formal communication when he returns.

In general, the Department supports reforms in the tax codes which reduce the overall tax burden, improve equity in tax treatment, reduce distortions in resource allocation, reduce inflationary pressures, and promote a sound and equitable economic structure of the farm sector and the entire food system.

The Secretary has a particular interest in seeing that further revisions in tax laws do not abet the inflationary spiral in land prices or promote undesirable changes in the structure of farming.

We support the proposed overall reduction in personal and business income taxes. However, it is difficult to judge the overall impact of these cuts until we know more about how they are to be distributed among income classes.

The three additional specific proposals of particular interest to agricultural and forestry concerns are: (1) the taxation of capital gains as ordinary income; (2) eliminating the accrual accounting exception for large farm corporations; and (3) taxation of gains at death.

Before commenting on the three proposals separately I note that as best we can estimate, the net effect of all proposed revisions will be to lower tax liabilities for most individuals; even including those with farm income who now declare capital gains. However, the increases in tax liabilities could be substantial for a relatively small number of large firms and high income individuals.

The major impact of eliminating the capital gains exclusion will occur in forestry, land sales, and farm businesses characterized by productive stock such as breeding herds, orchards, and vineyards.

Analysis of IRS tax tables indicate that while the impact will vary considerably by type of farm, the overall increase in tax liabilities to the farming sector resulting from elimination of capital gains will be less than \$½ billion annually, after allowance for the overall tax reduction.

Elimination of special capital gains treatment could on the one hand reduce the attractiveness of farm land as an investment, thereby reducing inflationary pressures on land prices, while on the other hand enhancing a "lock-in" effect on the ownership of land.

The proposal to eliminate the exemption from the accrual accounting requirement for large farm corporations where one family owns at least 50 percent of the stock will affect only a few large farms. They appear to be generally concentrated in the poultry industry and a few Western States. The egg industry has already sought Federal legislation requiring accrual accounting for their industry. This Department is on record as favoring the gradual elimination of the right of commercial farmers to use cash accounting for tax purposes.

Your third proposal would require taxation (as ordinary income) of all capital gains at an individual's death. However you indicated that exceptions will be allowed if the estate passes to a spouse or to children actively involved in farming. However assets placed in trust would be subject to the gains tax at the time of transfer into trusts. The exception for spouses and heirs who are bona fide farmers will help to assure continuity of family farming enterprises. There are however some problems with these exceptions. The exception does discriminate against estates that consist mainly of nonfarm assets, so nonfarmers will have increased incentive to purchase farm land. Moreover, the provisions will tend to inhibit the transfer of farm businesses during an individual's lifetime. This could impact on agricultural productivity and on the availability of land to younger persons wishing to enter farming. The net effect of these exceptions could be upward pressure on land prices as interest grows in land ownership because of special tax treatment accorded qualifying farm land.

Although preferential tax treatment of farm land is politically popular, some possible unfavorable effects are: land ownership may gradually become an inherited right, land ownership becomes a tax shelter, and land prices could be forced higher. For these reasons we strongly urge that safeguarding be designed to minimize abuse of the preferential tax treatment of farm land accorded farmers. One specific improvement would be to tighten the definition of "material participation" to limit the benefits to bona fide farmers as nearly as possible.

The impact of elimination of capital gains treatment on the timber industry deserves further comment. Short-run impacts could be disruptive for timber markets. If timber farmers and land owners believe enactment of the proposals is likely they will want to accelerate harvest of their own timber to minimize income impacts. Timber farmers with their own timber may reduce purchases from the Federal government and other landowners. Short-term timber purchases could be depressed and markets disrupted. An extended phase-in period (5-10 years) for timber may be desirable.

Reduced cash flow to the lumber and plywood industry could slow expansion of plant capacity, the trend toward merging small farms into larger ones, and further reduce land acquisition by forestry firms. It would also tend to push lumber and plywood prices upward. Lumber and plywood shares of materials' markets may be reduced. Lumber imports could increase faster.

Long-run timber effects would be reduction in returns per acre and lower land prices. Timber supplies would be a little lower and prices could rise a bit faster offsetting some of the landowner losses in capital value.

We will continue our evaluation of the new tax proposals. The Department has considerable stake in these proposals. We would appreciate the opportunity for continued involvement in their development and evaluation.

HOWARD W. HJORT, Director of Economics,
Policy Analysis & Budget



MEMORANDUM FOR Michael Blumenthal

From: Juanita M. Kreps

Subject: Tax Reform

The development of the Administration's tax reform package has been based on three goals: simplicity, equity, and increased incentives for capital formation. The Department of Commerce has focused its attention on the goal of improved capital formation mindful, however, of the need to meet other reform objectives.

In the long-run these goals are mutually reinforcing; over the next two or three years, however, pursuing these goals simultaneously involves some significant tradeoffs:

-- The need for tax incentives to spur investment spending in the immediate future argues for increased use of direct investment stimulus, but wider use of these tax breaks may undermine the Congress and the public's confidence in our commitment to true tax reform.

-- Integration of corporate and personal taxes is a widely supported tax reform that will increase investment over the long haul, but it is a very uncertain way to stimulate investment immediately.

We have reviewed the latest Treasury tax reform package and are pleased that its investment provisions have been strengthened. The added investment stimulus, although still inadequate, partially compensates for the lowering of investor confidence that will accompany the treatment of capital gains as ordinary income. Treasury includes provisions to lower the corporate tax rate by two percentage points and to liberalize the investment tax credit (ITC) by extending these credits to



industrial structures and increasing the allowable ITC limit from 50 percent to 90 percent of the corporation's tax liability. In addition, Treasury proposes to allow full investment credit for pollution abatement facilities and early depreciation for lengthy construction projects. Despite added investment stimulus contained in the new package, Treasury continues to emphasize business tax reform, with more than half of the business tax revenue loss to be achieved through elimination of double taxation of corporate distributions to shareholders. The Treasury proposals reflect a conviction that reduced general business taxes in the long run are as powerful a stimulus to investment as are so-called direct investment proposals. Commerce feels that this position underestimates the immediate need for increased capital spending.

The Council of Economic Advisers on the other hand favors a larger corporate tax cut (three percentage points) and more direct investment stimulus in the form of both a liberalization of the ITC along lines proposed by Treasury and an increase in the asset depreciation range from 20 to 40 percent. The Council would postpone the integration of corporate and personal taxes on grounds that the effects on capital formation are difficult to estimate and certainly much slower acting than the traditional investment incentives. Commerce views this proposal as more likely to provide the needed capital spending, but unacceptable as a tax reform package.

These conflicting assessments of the appropriate measures to include in the tax reform package are a direct result of the high degree of uncertainty we face with respect to: (1) the strength of the economy in the next two to three years, (2) the impact of the various proposals on the economy, and (3) how the overall package will be perceived by the public and Congress. The Treasury tax reform proposals, which stress longer term investment incentives and tax reform, and the CEA proposals, which stress short-term direct investment incentives at the expense of tax reform, appear to only partially minimize these uncertainties.

Since the attitude of investors is critical to the success of the tax reform package, Commerce has consulted extensively with business on the general features of tax reform. The views of the business community on capital formation tax cuts are mixed, and depend in large part on the nature of each

industry. This is particularly true with respect to the issue of partial integration versus direct investment incentives such as the Investment Tax Credit (ITC). Those industries that are capital intensive, such as steel and autos, favor direct incentives such as a further liberalization of the ITC or accelerated depreciation. Less capital intensive industries, such as retail food and services, lean more heavily toward partial integration. The financial community clearly favors partial integration. A selection of business views on tax reform is attached.

On balance, based on our discussions, there appears to be more support in the business community for partial integration than for direct incentives. There are several reasons for this:

-- they believe there is a good chance of getting partial integration because both Long and Ullman support moving in this direction;

-- they perceive partial integration as true tax reform, while more liberal depreciation and the ITC are not considered reform;

-- they believe the long-term impact of partial integration will significantly strengthen the equity markets and allow corporations to decrease debt financing of capital investment;

-- finally, they believe that some form of partial integration will be necessary to offset the impact of taxing capital gains as ordinary income, if we want to avoid a major adverse impact on equity markets.

In view of these considerations and of our analysis of the CEA and Treasury proposals, Commerce feels that there is a more balanced package of proposals that will stimulate direct investment to achieve the President's economic goals, stimulate long-term investment, meet the goal of true tax reform and be politically acceptable to Congress.

The details of Commerce's tax reform recommendations are provided in two parts: Part I - Business Tax Reforms and Capital Formation Incentives, and Part II - Other Business Tax Proposals.

Part I - Business Tax Reforms and Capital Formation Incentives

Commerce's recommended business tax package includes:

- (1) A corporate tax cut of two percentage points
(cost: \$2.7 billion)
 - insures all corporations receive some benefits
 - broadens the base of business support for the reform package
- (2) Relief of double taxation of corporate distributions by allowing shareholders to claim a portion of the corporate tax paid (cost: \$4.7 billion)
 - reduces the resistance to taxing capital gains as ordinary income
 - tends to increase the share of GNP devoted to capital formation
 - reduces the present excessive dependency on debt financing by improving equity markets
- (3) Increase the investment credit limit to 90 percent of tax liability (cost: \$100 million)
 - increases investment incentive to high growth, low profit firms
- (4) Extend the investment tax credit to industrial plants (cost: \$1 billion)
 - removes artificial tax bias against investment in plant
 - provides immediate assistance to construction of industrial structures, a seriously lagging area in this recovery

- (5) Full investment credit for pollution abatement facilities (cost: \$100 million)
- will partially compensate for increased costs of environmental and safety regulations
 - would reduce business resistance to full compliance with environmental regulations
- (6) Allow depreciation to begin earlier for lengthy projects (cost: \$200 million)
- encourages investment in those industries that have long-term construction projects, such as utilities
- (7) An additional investment tax credit to be allowed during the next four years. The credit would be phased out to coincide with the added stimulus being generated by a phasing in of the elimination of the double taxation of dividends. The added investment tax credit would be structured so that a three percentage point additional ITC would be allowed in the first two years, reduced to two percentage points in the third and one percentage point the fourth year.
- increases investment sharply and certainly in the near-term when it is needed to boost the economic recovery, and during the period of transition associated with partial integration
 - avoids additional commitment to revenue loss beyond this transition period
 - utilizes traditional proven method of direct investment incentive.

The Commerce package would increase the revenue loss expected under the Treasury package by the amount of the additional investment tax credit (item 7). Revenue loss would be approximately \$1 billion for each percentage point increase in the investment tax, i.e. \$3 billion for the first two years, \$2 billion the third year, and \$1 billion for the fourth year, with no additional revenue loss beyond the fourth year. The revenue

loss of this package in the first year would be \$11.8 billion. This would be partially offset by a number of proposed Treasury business tax reforms which will increase revenues by approximately \$5 billion.

The first year, full effect net revenue loss in 1976 dollars, therefore, would be about \$6.8 billion. This net revenue loss would decline as the additional ITC phased out.

In estimating costs of business and personal revenue losses, integration should not be viewed only as a business tax cut since the benefits will go directly to shareholders representing a wide cross section of income groups. Coupled with reduction of the maximum tax to 50 percent and assuming elimination of capital gains tax, the Department of Commerce believes that such integration will produce vigorous stimulation of capital markets with predictable increases in business confidence and capital available for investment. The added direct investment stimulus which we are recommending will help insure that capital spending is also adequate in the short-run to fulfill our economic goals.

Part II - Other Business Tax Proposals

1. DISC

Commerce believes that the DISC program has made some contribution to the increase in U.S. exports. In particular, the changes in the 1976 Tax Reduction Act that linked tax deferrals to increments in exports corrected some of the major shortcomings of the DISC tax incentive. We are aware that there is widespread belief that DISC benefits are not cost effective (based on the experience under the old DISC program) and agree that the elimination of DISC will increase popular support for the tax reform package. Accordingly, we recommend that the DISC tax incentive be phased out gradually by reducing the share of DISC profits eligible for deferral. This would also maintain DISC benefits as a bargaining chip for use in the GATT Multilateral Trade Negotiations, if the phase-out is conditioned on comparable modifications of export tax incentives used by some of our trading partners. Commerce strongly opposes any measures that would recapture deferred taxes on DISC profits.

This would be contrary to the general intent of Congress and contrary to the legitimate expectations of exporters.

2. Deferral of Taxes on Foreign Subsidiaries

Commerce supports the Treasury position to continue deferral of taxes on undistributed earnings of controlled foreign corporations. The present practice of not taxing foreign source income until returned to U.S. shareholders should be continued because: (1) other countries do not tax earnings of their overseas corporate holdings until such income is repatriated, (2) it would tend to discourage U.S. investment in low tax countries (often LDCs), (3) it may induce foreign governments to place a withholding tax on the constructive dividends implicit in ending tax deferral and (4) a past Treasury study has indicated that under certain conditions the removal of the deferral may actually lose revenue.

3. Tax Treatment of U.S. Income of Foreign Shippers

Commerce agrees in principle with this proposal, which would change current rules for the exemption of shipping income and discourage the use of flags of convenience and tax havens. Based on our preliminary understanding of the proposed rules changes, however, the Maritime Administration has raised some questions about the proposal which we recommend Treasury consider: (1) it may bring retaliation from those countries with whom we do not have treaties; (2) it could encourage developing nations to impose their own shipping taxes; (3) it may be ineffective against state-controlled merchant fleets, which will resist being taxed as a private enterprise; and (4) it may not succeed in taxing shippers using flag-of-convenience registry since nations such as Panama and Liberia can enact a tax exemption for U.S. flag ships thus putting pressure on the U.S. to grant them an exemption.

4. Repeal of the Ribicoff Amendment

The Ribicoff Amendment, an amendment to the Tax Reduction Act of 1976, denies certain tax benefits for prohibited participation in certain international boycotts. At a time when Congress was debating a broader statutory scheme, the Ribicoff Amendment was the only anti-boycott provision enacted. Until enactment of the Export Administration Act amendments in June of this year the Ribicoff Amendment was the only statutory provision containing

significant anti-boycott proscriptions.

The new anti-boycott law (Export Administration Act amendments) is a comprehensive, detailed statutory scheme that prohibits specified types of participation in unsanctioned foreign boycotts. It was enacted after extensive Congressional consideration and was based on the agreement negotiated between the Business Roundtable and leading Jewish groups. When this new law becomes effective in January 1978, however, there will exist two separate and unrelated sets of anti-boycott laws.

It is therefore timely for the Administration to propose repeal of the Ribicoff Amendment for the following reasons:

a. Sound public policy. The new law contains comprehensive and very specific anti-boycott prohibitions. It prohibits essentially the same types of behavior that the Ribicoff Amendment sought to reach. With both laws in effect, businesses will be subject to duplicative reporting requirements, separate and overlapping (but not identical) prohibitions, and inconsistent exceptions. This scheme is plainly inconsistent with sound public policy.

b. Tax Reform. Repeal of the Ribicoff Amendment would be a significant tax reform measure, appropriate for inclusion in the tax reform package, because the Ribicoff Amendment used the tax code for purposes essentially unrelated to taxes or revenues.

c. Elimination of Ribicoff sanctions. Certain of the sanctions embodied in the Ribicoff Amendment are based on tax benefits (e.g., DISC) that may themselves be repealed.

d. Diplomatic and political advantages. A proposal to eliminate the largely duplicative Ribicoff Amendment would be welcomed by the Arab world and the business community, both of which will be affected negatively by the new anti-boycott law.

Attachment

BUSINESS VIEWS ON TAX REFORM

Following are selected comments from business leaders on tax reform:

1. Appliances

Partial integration is preferred for the following reasons: 1) it is true tax reform that has been needed for a long time; 2) there is strong support in the Congress and the President had made strong commitments himself during the campaign; 3) it is essential to have partial integration and some cut in the rates to offset the adverse impact of taxing capital gains as ordinary income. Also, partial integration would be an important long-range reform that would improve equity markets and stimulate capital formation in the long run. ADR has been changed so many times that further changes would not be well received by the Congress and tax reformers.

2. Autos

The most dramatic impact on the entire business community would arise from rate reduction, which for any given revenue loss will produce greater capital investment. Historically, rate reduction has resulted in higher profits, investment and ultimately taxes. Tax reform aspirations must be balanced with the political practicalities involved in getting new legislation approved. They recognized that differences in industry would generate differences of emphasis.

3. Utilities

Partial integration was preferred because it appears to have political support on the Hill and because it represents a fundamental change in tax law that has been needed for a long time. They were not particularly enthusiastic about ADR, even though it would directly help this industry, because it would not be perceived as reform and because there is already substantial accelerated depreciation on the books.

4. Oil

Although direct incentives would be of more direct benefit to the petroleum industry, it was felt that the long-range benefits of partial integration were more important. The ability to finance capital formation would be greatly improved through some form of partial integration but full integration would be required to offset the impact of treating capital gains as ordinary income. Some combination of partial integration and direct investment incentives would be the best strategy to follow in view of the uncertainties about the economic outlook and the impact of these various tax proposals.

5. Insurance

Direct incentives would be preferred because of the uncertain effects on the equity markets of any change in capital gains and the implementation of partial integration. They argued that there are no solid analyses of the ultimate impact of partial integration.

6. Banking

The principle of rate reduction is in some respects more important than the absolute amount. A two percentage point reduction, coupled with selected direct investment incentives would be more attractive to the overall number of businessmen than a larger rate reduction without the direct investment incentives. A change in ADR would be appealing, but is sure to be seen as a giveaway to business and they doubted very much whether there was enough political support for it. They would opt for a somewhat smaller rate cut and the inclusion of integration. Most board rooms have really not made up their minds on the question we are pursuing -- this is, the balance among the several factors and what their preferences are.

7. Securities

Integration at this point is timely and should have a predictable positive impact on investment in securities, especially if it is coupled with a reduction of the maximum rate from 70% to 50%. Such a reaction will increase the appeal of equities and will as a consequence make equity capital, which has been relatively difficult to come by in recent years, much more accessible to the entire business community.

Federal Home Loan Bank Board



320 First Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

August 26, 1977

The Honorable Laurence N. Woodworth
Assistant Secretary
Tax Policy
Treasury Building
Room 3112
15th and Pennsylvania Ave., N.W.
Washington, D. C. 20220

HAND DELIVER

Dear Mr. Woodworth:

I have discussed with the Board the various tax reform measures which were outlined orally, and in the most general terms, by the Treasury Department staff yesterday, August 25, 1977. It is our understanding that these proposals will be presented to the President in the near future.

The Board is of the opinion, based on the brief general information presented, that the subject proposals have far reaching implications for thrift institutions, the housing industry, home buyers and savers which deserve the most careful scrutiny and analysis.

In order to achieve a thorough understanding of all of the ramifications of Treasury's proposals so as to prepare meaningful substantive comments, I think that you will understand that the Board would need more time than it was given in this instance so as to analyze the material and to prepare a well-considered response. Therefore, we sincerely regret that we are unable to provide you, at this time, with our substantive comments.

Speaking generally, the Board would like to participate in the formulation of policy that could have a major impact on the thrift and home-financing industries and on savers and homebuyers. To the extent feasible, therefore, we would appreciate it if you would attempt to present proposals and recommendations respecting the foregoing to us as early as practical, given the time constraints under which you must operate. We, obviously, can provide you with greater

assistance if we are given as much time as is possible to work on the matter.

As for the Treasury recommendations which were unveiled yesterday afternoon, the Board would appreciate very much having an opportunity to express its views about them at a somewhat later time during the Administration's evaluation process, or as the proposals proceed through the legislative process. You may be sure that we will give you our maximum cooperation and assistance in this matter on a priority basis.

Very truly yours,

Daniel J. Goldberg
Daniel J. Goldberg
Acting General Counsel

cc: Daniel I. Halperin



THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D. C. 20201

August 19, 1977

MEMORANDUM FOR THE HONORABLE MICHAEL BLUMENTHAL

Subject: Tax Reform

My staff has been in touch with yours over the past several weeks about the Treasury's plans for tax reform. While I continue to have some personal reservations about the proposal for the integration of personal and corporate income taxation, three other aspects of the tax reform proposal are of more direct HEW concern.

- o The integration of our proposed welfare reform package, the Earned Income Tax Credit, and Federal income tax system.
- o The proposal to change the deductability of excess medical expenses and the employee share of health insurance premiums.
- o The proposal to include in taxable income some portion of social insurance benefits, especially Social Security.

Welfare and Tax Integration

To the greatest possible extent, the welfare system and Federal personal income tax should be dovetailed so that a family receives cash assistance or pays taxes, but not both. We recognize that accounting period and filing unit differences prevent mutual exclusivity in all cases. Nonetheless, we should seek to minimize potential overlaps for both theoretical and administrative reasons.

- o Under the proposed welfare reform system, reduction rates will vary, depending on a family's demographic characteristics, from 50% to 70%. If those rates overlap with the tax system, given Treasury's proposed rate schedules, cumulative marginal tax rates for some families over some range could rise to anywhere from 70% to 100%. The Social Security payroll tax could take the combined rate over 100% in some cases. The work disincentives and inequities resulting from such overlaps are potentially severe.
- o The alternative of reimbursing Federal tax withholding as part of the computation of a family's welfare benefit has several disadvantages:
 - Welfare eligibility ceilings ("breakevens") are pushed to higher income levels causing increased coverage and higher welfare costs.

- The potential for error and abuse in welfare administration, and, therefore, administrative costs to minimize that potential are both increased.
- Inequity between those who apply for their "tax relief" through the welfare program and those who forego that relief by choosing not to participate in the welfare program.
- o Any overlap between the welfare program and the tax system results in the anomaly that at the same time a family's Earned Income Tax Credit is being reduced, the welfare program would reimburse all or some of that reduction in its benefit computation.

We understand that you may be thinking about a phase-in of the personal income tax reductions. I propose that our staffs work together to evolve some phase-in alternatives that would result in a clean interlock between the tax system and the welfare program in 1981, our proposed implementation year. Our goal should be one in which a family is eligible for cash assistance or is required to pay taxes, but not both.

A special aspect of the overlap problems is the continued difference between married joint units and head of household units in the tax system. We recognize the "marriage penalty" problems that would result from an attempt to close the difference. However, as part of our staff discussions, I would like to see whether some manipulation of the standard deduction, the proposed credit for earnings by the lesser-earnings spouse, and the child care credit could allow us to close the difference and, perhaps, eliminate the overlap.

Also, I would like to have our staffs explore the possibility of increasing the EITC as the payroll tax increases over time or if it takes on added significance in a national health insurance program. We prefer to view the Federal income tax structure as a totality and its progressivity as the product of the personal income tax, the payroll taxes and the corporate tax. Your proposed rate schedule and the change to the personal credit, combined with the expanded EITC, yields a favorable pattern of progressivity even when the employee share of the Social Security payroll tax is also taken into account. I hope we will try to preserve this desirable pattern as the payroll tax goes up, and the EITC offers us a convenient vehicle to do so.

Medicaid Expenses Deduction

I feel strongly that this is the wrong time to propose changes in the medical tax deduction, for three reasons:

- o First, whatever its deficiencies, that deduction is the closest system the country now has to a universal scheme for financing access to health services. Attempts by the Kennedy and Johnson Administrations to raise the medical deduction floor were unsuccessful; a primary reason was that proposed changes in the deduction were not counter-balanced by other efforts to finance uncovered medical expenditures.
- o Second, the President is committed both to balancing the budget by 1981 and to the enactment of a true national health insurance plan. HEW is currently in the early stages of developing such a plan for the President. The Administration should not prematurely surrender an important potential source of financing of national health insurance. It is not satisfactory to " earmark" for NHI the revenue obtained by a change in this deduction if that revenue is used to support other tax reductions. The fiscal scope for NHI depends on the actual full employment budget in 1981 and is not affected in any way if the revenues from a change in this deduction are earmarked for one purpose or another.
- o Third, our NHI proposals may include personal income tax modifications — especially tax credits — as integral components in their design. We should not foreclose those options by proposing a change in the tax system that we would ask Congress to reverse next year.

I recognize that raising the medical deduction floor appears desirable in the context of tax simplification and/or reform, and if that were the only context, I would be inclined to support the change. But given the President's commitment to national health insurance, I think that the deduction for medical expenses should be addressed as both an element of tax policy and as an element of health policy in the context of the NHI deliberations in which Treasury staff is already participating.

Taxation of Wage Replacement Programs

HEW supports in principle the taxation of certain Social Security benefits. Our one major reservation is political: any such proposal may invite the Congress to reopen the question of expensive liberalizations of the earnings or "retirement" test in Social Security.

The proposal to tax the benefits of retired workers and older survivors (widows, widowers, and parents) is equitable so long as:

- o the income thresholds and phase-in rate for including social Security income correspond to the phase-out point and phase-out rate in the special retirement income credit for the elderly.
- o a fraction of benefits corresponding to the workers contribution remains fully tax exempt.
- o parallel treatment is accorded similar contributory government programs such as railroad retirement.
- o similar treatment -- but without the one-third exemption -- is accorded similar noncontributory programs such as black lung.

Of course, we recognize that political considerations may force violation of one or more of these principles.

We believe that Social Security payments to young survivors should remain entirely tax exempt to accord with the treatment of private life insurance. Young survivors include the children of deceased workers and those surviving spouses that are entitled solely because of the entitled children.

We favor application of the same rules to disability insurance benefits as are applied to retired worker benefits. Although we recognize that this procedure would not treat Social Security payments in the same manner as private disability insurance, we prefer to maintain parallel treatment for disability and retirement benefits. From an equity standpoint, the tax treatment of black lung disability payments and workman's compensation payments should be consistent with the tax treatment of Social Security disability payments. We would support the taxation of unemployment insurance benefits in a manner consistent with taxation of Social Security retirement benefits.

In closing, let me acknowledge the time Treasury staff has spent already with HEW staff. I appreciate your accommodations concerning the EITC; I am gratified at a number of improvements in the tax package made in the past couple of months - notably the move toward constructive

realization of capital gains at death. Enactment of your proposal will be a milestone in tax reform. I am confident that we can work out the few remaining issues.

for *Apple Champion*
Joseph A. Califano, Jr.



THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D. C. 20410

September 6, 1977

Honorable W. Michael Blumenthal
Secretary of the Treasury
Treasury Department
Washington, D.C. 20220

Dear Mike:

I appreciate the opportunity which you have given to me and my staff to become acquainted with the proposals for tax reform which are presently under consideration in your Department.

I heartily endorse this Administration's commitment to tax reform, and the elimination of the inequities which have characterized our tax system. Tax reform is vital to the improved efficiency of our economy, and to our people's perception of their government.

I would like, at this time, to comment on the tax reform proposals as they relate to housing policy. I am also preparing, for your consideration, an analysis of the cumulative impact of the proposed changes on urban development.

1. Tax Reform Proposals Relating
to Owner-Occupied Housing

Tax subsidies available to homeowners are palpable and direct -- each homeowner claims deductions for his mortgage interest and property taxes on his personal tax return. The Committee on Budget of the U.S. Senate has estimated the "tax expenditure" involved in the deductibility of mortgage interest and property taxes on owner-occupied property to be \$8,535 million in 1977. In addition, a less visible though more significant tax subsidy to homeowners is the absence of imputed income arising from the rental value of an owner-occupied house. See, Goode, The Individual Income Tax, 121 (1964).

The tax reform proposals affecting homeowners are as follows:

A. Limitation on Deduction of Mortgage Interest

It has been proposed that the amount of interest which can be claimed as a personal deduction be limited to \$10,000.00. Included within the amount subject to the limitation would be interest on home mortgages and on consumer finance loans. This proposal will affect persons owning houses with mortgages in excess of \$125,000 (less than 2% of all homeowners) and possibly persons with mortgages on both a primary residence and vacation or resort home. 1/

B. Taxation on Sale of Owner-Occupied Homes

It has been proposed that preferential rates of tax on the gain from the sale or exchange of capital assets be eliminated. All such gain will be taxed at ordinary income rates. There will be a special provision, however, somewhat similar to §121 of the Code, excluding from gross income the amount of gain on the sale of a personal residence computed as follows:

$$\frac{\$75,000}{\text{Sales Price}} \times \text{Gain} = \text{Amount Excluded from Income}$$

Any gain on the sale of a personal residence not excluded from income by the foregoing formula is to be taxed at ordinary income rates. An

1/ Because of the uncertain relationship between the interest deduction and the amount of depreciation and expenses that can offset rental income from vacation houses (see §280A(c)(4)), it is not clear whether the proposed limit on the interest deduction would adversely affect the owners of vacation or resort homes.

individual can use the exclusion ratio described above as often as once a year, and there will be no carryover feature reducing the basis of a subsequently acquired home to reflect the exclusion from income. The privilege granted by §1034 of the Code to defer tax on the sale of a personal residence by re-investing the gain in a new residence, with a carryover basis, will still be available.

The net effect of the proposed change will be to decrease the rate of tax on non-reinvested gain from the sale of a home for a price less than \$150,000.00, and to increase the rate of tax on non-reinvested gain from the sale of a home in excess of that amount.

With the exception of the items cited above, the major tax subsidies to owner-occupants of private homes will remain intact. Subject to the limitation of \$10,000.00 on interest, mortgage interest and property taxes will continue to be deductible, and there will be no imputed rent from the occupancy of the house. If anything, the change in the treatment of gain on the sale of a personal residence will increase the tax subsidy to homeownership, except for those at the very top of the income spectrum.

The proposed reforms will have an adverse impact on the owner-occupants of houses with a value in excess of \$125,000.00. The occupants of such houses spend a relatively low percentage of their income on housing needs, and are outside the area of special concern of our Department.

2. Tax Reform Proposals Relating to Multi-Family Rental Housing

The Internal Revenue Code confers no direct housing-related tax deductions on renters. Tax incentives have, however, attracted capital to the construction of rental housing. The housing investor's return from rentals has been augmented

by tax savings, which makes possible marginally lower rents. The Senate Committee on Budget determined that the tax subsidy from depreciation on rental housing in excess of straight-line depreciation involves a tax expenditure for 1977 of \$580 million. Using a slightly different approach, the Congressional Budget Office has determined that the revenue loss in tax shelters for all rental housing is approximately \$850 million.

Multi-family rental properties will be affected by general changes in the tax system which are not directed specifically at real estate.

The taxation of all gain at ordinary income rates means that there will be full "recapture" of depreciation deductions upon the sale or other disposition of a building. Thus, although some deferral of income may still be possible through depreciation, the ability to convert ordinary deductions to capital gain will be eliminated. Losses on the sale or exchange of real property will be fully deductible against ordinary income.

Although this change reduces the rate of return on real estate investment, it similarly affects the rate of return on all investment. I support this elimination of preferential tax treatment of capital gains.

The provision for losses will, to some extent, mitigate the somewhat stringent rules for depreciation discussed below. However, the restrictions on depreciation combined with the allowance of losses could have unfortunate implications for housing. Owners might prematurely dispose of property in order to recognize economic losses not allowable under the proposed new system for depreciation.

There are certain proposed changes in the law which deal directly with housing. The Treasury has proposed that it develop a new comprehensive system for allowing annual deductions reflecting the annual unrealized decline in value of buildings. The first step in implementation of this new system will be a three-year interim period for the

collection of information as to actual sales of used buildings. The sales prices for used buildings will provide the basis for determining the decline in value of buildings.

During the three-year interim period, the depreciation of structures will be subject to the following limitations:

- (i) Accelerated depreciation will be eliminated.
- (ii) Useful life will be based on new mandatory guidelines determined from the useful lives claimed by taxpayers in the past. We have not ascertained whether these lives will take into account component depreciation, which can be quite important in the case of high-rise rental projects.
- (iii) Depreciation computed in accordance with (i) and (ii) above will be limited to the equity in real property. This is so even though the taxpayer is "at risk" with respect to the mortgage. I have been advised that the purpose of this rule is to limit depreciation to amounts that reflect in some way the actual economic decline in property value. The theory of the limitation is that a bank or other lending institution would not permit a mortgage balance to exceed the value of the property at any given time.

At the end of the three-year interim period, tables setting forth allowable annual deductions will be published by the Treasury. These tables will categorize buildings according to their use, age, location, and other relevant factors. Categories of buildings with no actual decline in value will be allowed only nominal annual deductions. Structures which decline rapidly in value will be permitted substantial annual deductions.

The Treasury would permit taxpayers to elect to deduct an amount determined in accordance with the tables, or to continue to claim deductions subject to the limitations described above for the three-year interim period.

A. Non-Subsidized Multi-Family Housing

The construction of rental housing, as you know, requires vast amounts of capital. Investments in housing have certain inherently unattractive features, such as slow recovery of invested capital and high risk. Because of these factors, investment in multi-family housing, even under today's tax system, has been depressed.

A substantial portion of the overall cost of housing comes from borrowed funds, much of which is provided through some form of government assistance. Much of the equity capital which is invested in housing today comes from syndicates of investors, commonly referred to as "tax shelters". Tax shelters, by and large, consist of individuals who are responding to tax incentives by investing their funds in housing.

I am well aware of the public dissatisfaction with syndicated tax shelters, and with certain inherent inefficiencies of tax shelters as a vehicle of production. Notwithstanding these deficiencies, however, tax shelters presently raise the equity capital which is critical to housing construction.

The proposed changes in the tax law will substantially reduce the rate of return on housing tax shelters. Based on a model of new multi-family housing developed by Professor William B. Brueggeman of Ohio State University, we have concluded that a limitation of depreciation to straight line, combined with a limitation of depreciation to the amount of invested equity, will reduce the rate of return on a typical new non-subsidized housing development from 13.3% to 10.4%.

If such a decline in the return from housing investment were reflective of a general increase in the taxation of all capital, then possibly housing could continue to compete in the equity markets for equity investment capital.

We are aware, however, that there are several proposals under consideration which will continue or create

tax-favored investment opportunities, such as the continued deductibility of intangible drilling expenses (subject only to the minimum tax), and the allowance of an investment credit for industrial structures.

I am concerned that tax shelters will continue to proliferate, offering investments in oil and gas, ^{2/} or investments featuring the credit for construction of industrial structures. ^{3/} The natural market for such syndicates is composed of individuals who presently invest in housing tax shelters. Thus, even if all tax reform proposals were to be enacted, some individuals would continue to be able to effect significant reductions in their income tax liability, and the activities of promoters and syndicators would continue. The only net change arising from the tax reform effort would be that funds which formerly went to housing would be diverted to oil and gas and industrial structure investments.

Direct corporate investment is also being accorded more favorable tax treatment. A reduction in corporate rates, along with partial integration (with flow-through of investment credit), could enable certain corporate stocks to compete successfully for equity funds which presently are invested in housing.

^{2/} The at risk limitation of Section 465 of the Code is not effective to limit such a shelter. The at risk limitation does not affect oil shelters, since typically no leverage is used in drilling. Also, even with the inclusion of intangibles in the minimum tax, a wealthy taxpayer can convert income taxable at 50% to income taxable at 15% or less, depending upon the other taxes he pays.

^{3/} The at risk limitations do not affect the amount of investment credit that taxpayers can claim. Substantial leverage can typically be obtained for industrial structures. The shelter opportunities are obvious.

I do not believe that it can be shown that the oil and gas industry, or industry generally, is in greater need of tax incentives to raise capital than is housing. Housing construction can play a major stimulative role in the economy, and can significantly expand employment opportunities for both skilled and unskilled workers. In addition, of course, there is an acutely human side to the housing crisis which should not be ignored by this Administration.

I would look with sympathy on comprehensive tax reform, even if it reduced housing subsidies, so long, and only so long, as competing investment media were similarly affected. I cannot endorse a tax reform proposal which results in the movement of equity capital from housing to other industries. Nor do I believe that this Administration, with its strong commitment to social justice, can justify a reform package which favors investment in areas such as oil and gas and industrial construction, at the cost of, and to the detriment of, our housing program.

B. Subsidized Housing

In the Tax Reform Act of 1976, the effective date of the limitation on the deductibility of construction period taxes and interest was delayed, with respect to low income housing, until 1982. See §189 of the Code. I understand that your present proposals leave §189 intact. Consequently, after December 31, 1982, a major tax incentive will be removed from the construction of low income housing. In addition, you have indicated that the proposals outlined above for limiting depreciation are to be made partially applicable to subsidized housing.

The reform proposed for depreciation generally is not appropriate for subsidized housing. In the first place, the proposed system gives no weight to the compelling social policies which support favorable tax treatment for subsidized housing. In addition, the proposed economic methodology does not relate properly to subsidized housing.

Subsidized housing projects are seldom, if ever, sold since existing projects offer little profit potential to prospective buyers. Actual sales prices, therefore, do

not provide a means of evaluating decline in the value of such a project. Indeed, any measurement of value, or of decline in value, in the context of subsidized housing, must reflect the particular nature of subsidized housing investments, and the economic distinctions between subsidized and non-subsidized projects.

The theory behind the proposal to limit depreciation seems to take into account two factors generally present in real estate investment: the projection of continuing cash flow, and the expectation of capital appreciation. In most real estate ventures, these factors are, in large part, determinative of value, and provide an incentive for investment and maintenance, assuming that other areas of investment are not given greater tax preferences.

Subsidized housing, however, provides no incentive for investment in either of these two respects. First, little or no positive cash flow can be projected. The tenuous financial situation of the tenants, and the management problems of dealing with large families which require special attention to social needs, combine to eliminate any expectation of cash yield. Second, because of the nature of the use of the housing and, very often, its location, there is little prospect of capital appreciation. The proposals which you are considering therefore appear to be based upon economic assumptions which, while they may be appropriate for most real estate investments, are not really applicable in the context of subsidized housing.

I am convinced that construction of subsidized housing will virtually cease if present provisions for accelerated depreciation are eliminated, or even reduced. I therefore request that subsidized housing be excluded from the proposed limitations on depreciation. To the extent that some change in the nature of the tax incentives currently available to subsidized housing may be appropriate, I believe that such change should be specifically considered by our two Departments, and that an effort should be made to develop proposals which are directly responsive to the particular nature of subsidized housing, rather than to the general nature of real estate investment.

== You have asked our Department for a recommended ==

definition of subsidized housing. We feel that the definition now found in §1250(a)(1)(B) of the Code is satisfactory.

3. Tax Reform Proposals Relating to
Housing Authority Bonds

We have been advised that you are presently considering a proposal which would institute a "taxable bond option" with respect to municipal bonds described in Section 103(a) of the Code. We intend to respond to this proposal, in greater detail, in the urban impact statement currently being prepared for your consideration. One feature of the proposal, however, should be noted here.

We understand that you are considering, in connection with the taxable bond option, a termination of the exclusion from gross income of interest realized on industrial development bonds as defined in Section 103(b). Included within the present definition of industrial development bonds are bonds substantially all of the proceeds of which are used to provide residential real property for family units (Section 103(b)(4)(A)).

State housing authorities which issue tax exempt bonds are a vital source of mortgage money for our Section 8 program and for similar housing programs conducted by states. In 1977, approximately \$2 billion in mortgage money was made available through this medium. At least 40% of the new Section 8 program was financed with funds raised with tax-exempt bonds. Any significant change in the market status of such bonds could cripple one of our most successful programs and retard the construction of low income housing.

A termination of the interest income exclusion presently provided by Section 103(b) would have an immediate and adverse impact on the sale of housing authority and similar bonds, unless some alternative provision is made to preserve this important market. I therefore request that, in the event of a change in the present provisions of Section 103(b), bonds which are issued to raise money for low, moderate and middle income housing be included by definition within the category of bonds to be covered by the taxable bond option.

4. Tax Reform Proposals Relating to Thrift Institutions

Section 593 of the Code permits "domestic building and loan associations" a deduction for a bad debt reserve artificially set, for 1979 and later years, at 40% of taxable income. In order to qualify for the full amount of this deduction, a building and loan association must invest 82% of its total assets in residential mortgages, and certain other classes of property. (Code §7701(a)(19)). A reduction in the bad debt allowance for mortgage lenders from 40% to 20% of taxable income is presently under consideration.

To the extent that tax advantages of qualifying as a domestic building and loan association are reduced, the incentive to qualify will likewise be reduced. To the extent that other investments have returns comparable to or greater than residential mortgages, the building and loan associations will have a reduced tax incentive to invest in residential mortgages. There is presently an increase in investment in tax-exempt bonds by building and loan associations. An analysis by Professor Patrick Hendershott of Purdue University suggests that a reduction in the bad debt deduction to 20% will result in the withdrawal of funds from residential mortgages at the rate of about \$3 billion per year for each of the next six years. Such a massive redeployment of savings from residential mortgages to other investment media could have a serious impact on the production of housing.

In addition to the items discussed above, it has come to our attention that consideration is being given, within your Department, to a modification of the rules concerning the classification of organizations as partnerships or corporations. See Treas. Regs. §301.7701-2. As you know, any administrative change in these regulations, comparable to the changes proposed last year, could have an extremely adverse impact on housing construction. I do not believe, therefore, that any determination should be made as to a modification of these regulations without serious consideration being given to the effect of such a modification

on housing policy. An issue of this magnitude should be resolved jointly by our Departments, and I therefore request that we be given an opportunity to work with you toward an acceptable solution to this problem.

The foregoing comments and suggestions are made with the hope that we can coordinate the goals of tax reform with the housing goals of this Department. I will be happy to discuss these matters with you further, or to provide any additional information which might be helpful to you in evaluating these proposals.

Sincerely,

Pat

Patricia Roberts Harris



United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

September 2, 1977

Hon. W. Michael Blumenthal
Secretary of the Treasury
Washington, D. C. 20220

Dear Mr. Secretary:

Phase-out of the percentage depletion allowance allowed the mining industry has been suggested for inclusion in the tax reform proposals to be recommended to President Carter.

I most strongly urge that percentage depletion not be included in this package.

The issue at this time is not whether the percentage depletion allowance is a proper, viable, or fair tax measure. Rather, the question is one of timing. Given other activities currently underway, this is a poor time to suggest elimination of this tax measure. Major considerations are:

(1) The Administration will send to Congress a major reform of the Mining Law of 1872 in the next two weeks. This reform will add costs in the form of royalty payments and reclamation requirements which the mining industry has not borne before.

(2) At the request of the President, Dr. Frank Press and the Department of the Interior will be leading an interagency study on non-fuels minerals policy. The form of this study will be a domestic PRM. This interagency review group will submit options and recommendations to the President within 12 months, and the entire tax picture as it relates to the mining industry should be a part of that review. The Department of the Treasury, of course, will be an invited participant. Since depletion allowances are only one factor affecting the mining industry and the report will likely recommend a series of related changes and factors affecting the mining industry, it appears premature to change the depletion allowance now.

(3) This Administration wishes to promote competition in business and industry, including the mining industry. As you know, the mining industry is capital intensive and the percentage depletion allowance

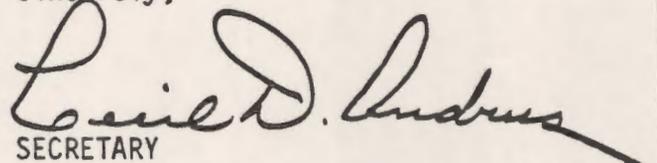
is an especially important source of the capital required by smaller mining firms. Without more extensive analysis of the impact of eliminating the depletion allowance we may in fact be giving the larger mining companies an even greater advantage.

(4) For the most part, the metals mining industry of the United States is in a period of financial difficulties, and it is not likely this situation will be corrected in the near future.

(5) Finally, the timing of this move in an overall sense is not good. This would be another measure having a heavy impact on the Western States. These States have already been heavily affected by major changes in policy, including water policy.

In summary, I believe this is an economic question affecting the United States mining industry and should be resolved by a study of that industry and not a study of the overall tax policy. The more proper arena for resolution of questions relating to percentage depletion allowance would be the interagency review of the Nation's mineral policy. I would be happy to discuss this matter further with you.

Sincerely,


SECRETARY

U. S. DEPARTMENT OF LABOR

OFFICE OF THE SECRETARY

WASHINGTON

AUG 18 1977

MEMORANDUM FOR: THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY

FROM: SECRETARY OF LABOR *K. M.*

SUBJECT: Tax Reform Proposals

Following your presentation last week, members of my staff met with Treasury officials to learn in more detail about the proposed tax reform proposals. I have been heartened to learn of the general direction of the current program. Many of the concerns I originally expressed have been met either through modification of the original proposals or the addition of new ones. Let me add my appreciation for the openness and cooperation that your staff has extended to members of my staff.

There remain two aspects of the proposed program where I feel the proposals could be strengthened or modified, and I would therefore like to call to your attention the following points:

1. Deferral of Foreign Income

In the Administration's preparation of tax reform proposals, I am hopeful that serious consideration will be given to the important link between DISC (Domestic International Sales Corporation) and the deferral of non-repatriated foreign source income from U.S. corporate taxes. These two tax provisions have similar but offsetting impacts on decisions on whether to invest and produce abroad or to invest and produce -- and create jobs -- in the United States. In fact, the DISC was initially justified in 1971 on the grounds that it helped offset certain features of U.S. and foreign tax systems that favor

production abroad over production in the United States for sale abroad. The most important of these features highlighted in the Congressional debate was the deferral of non-repatriated foreign source income.

Simultaneous removal of the tax deferral benefit and the DISC subsidy would have a balanced effect on U.S. investment, production and employment. Moreover, two prominent flaws in our tax system would be removed at the same stroke, considerably improving the simplicity, economic neutrality, and political fairness of our tax system.

Numerous economic analyses have demonstrated the inefficiency and inequity of the DISC and deferral subsidies. Rather than recapitulate those technicalities which have already been made available to you, I simply suggest that the combination of eliminating both the DISC and deferral tax breaks would make sense from several different angles.

2. Taxation of Unemployment Benefits

The current Treasury proposal would tax unemployment benefits for filing units in the upper half of the income scale (above \$20,000 for families and \$15,000 for individuals). I think that a proposal of this sort, although controversial, could be accepted by the Congress since the vast majority of UI recipients would not be affected.

However, I am concerned with the effects of such a proposal over an extended period of time. With inflation and rising incomes, more and more taxpayers would encounter tax liability on any UI benefits. Eventually, the majority of UI recipients would be paying taxes on their benefits. This could prove quite unsettling to state UI laws and would certainly reduce the stabilizing effect of UI payments.

I would like to urge therefore that this proposal be modified to provide that the \$15,000 and \$20,000 income levels for tax liability be indexed by some measure of average earnings.



NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

GC/RMF:vhw
4640
August 26, 1977

Office of General Counsel

Mr. Daniel I. Halperin
Legislative Tax Counsel
Department of the Treasury
Washington, DC 20225

Dear Mr. Halperin:

This letter is to comment on certain tax reform proposals under consideration by the Treasury Department as outlined in the meeting held at the Department on Thursday, August 25, 1977, and attended by Mr. Robert Fenner of this Agency.

Of greatest concern to the National Credit Union Administration is the proposal to subject credit unions to Federal income taxation in a manner comparable to presently taxed thrift institutions. Initially, we object to any such proposal, and believe there is sufficient justification for maintaining the tax exempt status of credit unions.

As you know, credit unions are nonprofit, cooperative associations organized and owned by their members. Credit union membership is generally limited to those united by a common bond of occupation, association, or residence. (Almost 80% of credit unions are organized by occupational group.) As such, credit unions serve only personal financial needs of their members and not the banking needs of the general public. Further, a significant portion of all credit unions' activities, and indeed the entire function of many small credit unions, is performed by unpaid, volunteer staffs.

An examination of current credit union operations reveals that they continue to function as small, member-owned institutions providing limited savings and credit services. For example, a recent survey of credit unions



established that 50% of all credit unions had 400 members or less, and that 72% of such members had accounts of less than \$500. Almost 10 million loans were made by Federal credit unions in 1975, and the average size of these loans was just \$1,551. Approximately 8% of these loans were made for household and personal expenses, and fully 44% were unsecured. Only 2.8% were made to business. The common practice of many credit unions of providing year-end interest rebates to all borrowers, based on the amount of interest paid by each borrower, reinforces their cooperative nature. Thus, credit unions continue to function in the capacity for which they were created; as limited membership, cooperative financial institutions serving the needs of the average consumer. It is on this basis that we believe their exemption from Federal income taxation is justified. Indeed, an alteration of that status would seem to jeopardize the tax exempt status of the entire cooperative concept.

In addition to commenting on the general subject of taxation of credit unions, we wish to express certain concerns as to the equity of treating credit unions like other financial thrift institutions for tax purposes. As you are well aware, equity in the sense of statutory tax rates will not necessarily result in "effective tax rate" equity. In this regard, generous tax benefits which result to other financial institutions will not be available to credit unions, due to limitations on their powers and range of services.

For example, interest income on tax exempt municipal securities, depreciation realized through leasing operations and foreign tax credit will all be generally unavailable to credit unions under their present scheme of powers. Further, while treatment of credit unions like thrift institutions for tax purposes would subject them to the same rules on tax deductions for transfers to bad debt reserves, it is questionable whether credit unions would derive comparable tax benefits from this treatment. For example, savings and loan institutions presently derive their primary tax benefits through tax free transfers to qualifying loan reserves under the percentage of income method. The utility of this method to credit unions is at best questionable, however,

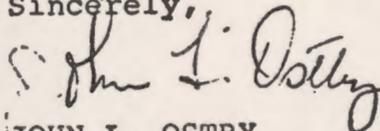
since it is conditioned upon an asset structure comprised largely of residential mortgages. (While Federal credit unions have recently obtained mortgage lending powers, it is anticipated that only a small percentage of the average credit union's assets will ever consist of such loans.)

We are concerned, therefore, with the possibility of adverse competitive impact upon credit unions and suggest that true tax equity requires a comprehensive reconsideration of the tax benefits available to all financial institutions.

Our final comment concerns the possibility that the Treasury Department's proposals will include some form of integration of corporate and individual income taxes. Although we have not thoroughly studied the various methods of accomplishing integration, we understand that they may involve taxation of corporate owners with respect to retained corporate earnings. Credit union members are clearly credit union owners. Their ownership interests exist, however, in the form of share (savings) accounts, and they are limited in the earnings they can realize on these accounts by management decisions and, more importantly, by regulatory dividend rate ceilings. Thus, credit union members realize on retained earnings, if at all, only in the event of liquidation. Imputation of retained earnings as income to credit union members, therefore, seems inappropriate, and we trust that any integration proposal will accommodate these considerations.

In closing, I wish to re-emphasize the National Credit Union Administration's primary concern, i.e., that credit unions should be allowed to retain their tax exempt status, on the bases discussed above. I wish to thank you for the opportunity to submit these comments, and I hope you will let us hear from you if we can assist you in any way.

Sincerely,



JOHN L. OSTBY
General Counsel

SMALL BUSINESS TAX REFORM

FIRST PRIORITY

1. Graduated 6-Step Corporate Tax

Now: The 48% tax rate begins on income over \$50,000 (with two intermediate steps).

Proposal:

<u>Taxable Income</u>	<u>Proposed Tax Rate</u>
\$ 0 to \$ 29,999	8%
30,000 to 59,000	\$ 2,400 + 16% of excess over \$ 30,000
60,000 to 89,999	7,200 + 24% of excess over 60,000
90,000 to 119,999	14,400 + 32% of excess over 90,000
120,000 to 149,999	24,000 + 40% of excess over 120,000
150,000 and over	36,000 + 48% of excess over 150,000

2. Deferral of Recognition of Gain from Sale of Interest in Small Business

IF Invested in Another Small Business Within 2 Years.

Now: Nothing

Proposal: No recognition if gains on sale of small business is invested in another small business within 2 years.

Limitation: Original investment must be held for 5 years and be eligible for redemption treatment; e. g. , not available to sole shareholder.

3. Faster Depreciation With Dollar Limits

Now: Present schedules require long depreciation time.

Proposal: Add a new method with special class lives by asset categories. Permits faster depreciation.

Limitation: Dollar limits of \$100,000 (\$200,000 for real estate) restrict principal advantage to small businesses.

4. Liberalize Subchapter S. Permit SBIC Investment.

Now: Subchapter S eligibility if no more than 10 individual shareholders. Limit on investment income.

Proposal: Increase number of shareholders to 25. Permit SBIC as shareholder.

5. Graduated Estate Tax Rate

Now: When fully phased in the estate and gift tax credit will be equivalent to an exemption of \$175,625. The tax rate on the net taxable estate in excess of this amount begins at 30%.

Proposal: The rate schedules should be modified to provide for a 10% rate on the net taxable estate in excess of \$175,625, with the rate graduated up to present rates on net taxable estates of \$1,000,000 and over.

6. Investment Tax Credit

Now: Limit on utilization of investment tax credit to the extent of profits.

Proposal: Allow businesses which cannot use entire investment tax credit to obtain a cash refund, or to carry forward or back.

SECOND PRIORITY

7. Qualified Stock Options Issued By Small Businesses

Now: Tax Reform Act of 1976 abolished stock options for all companies.

Proposal: Reinstate stock option for small business only.

8. Increase Limits on Ordinary Loss Deductions For Small Business Stock.

Now: Ordinary loss deduction may be taken on small business stock.

Limits:	Single Return:	\$25,000
	Joint Return:	\$50,000
	Offering Amount:	\$500,000
	Issuer Size:	\$1,000,000 In equity capital

Proposal: Double all amounts.

9. Underwriter Loss Reserve

Now: Nothing.

Proposal: Permit firm underwriter of small business securities to establish loss reserve of specific percentage of such underwritings and deduct from other income.

THIRD PRIORITY

10. All SBICs Permitted to Pass Through Income Without Tax

Now: Only SBICs registered under Investment Company Act of 1940 may pass through income without tax.

Proposal: All SBICs may do so.

11. SBIC Conversion

Now: SBICs interested in converting from corporate to partnership form incur tax liability.

Proposal: Permit SBICs to convert from corporate to partnership form tax-free.

12. SBIC Loss Reserve

Now: SBICs only authorized to deduct loss reserves for bad debt.

Proposal: Permit SBICs to deduct loss reserves for equity investments in small business from ordinary income.

DEPARTMENT OF STATE
WASHINGTON

August 26, 1977

Dear Mike:

Assistant Secretary Woodworth has asked for statements of the Department of State's positions on several tax issues which may be included in the Administration's tax reform proposals. All of these tax issues have important international implications. I understand that these statements will be sent to the President with Treasury's recommendations for tax legislation.

Tax Deferral - The Department of State urges the retention of the present system which allows U.S. corporations to defer taxation on the profits of their foreign subsidiaries until this profit is remitted. The elimination of deferral would make it more difficult for U.S. corporations to compete internationally. Moreover, given the increased collaboration of U.S. businesses abroad with local business or government, the difficulties of administering a tax on accrual would be great and would provoke charges of interference in the business activities of foreign countries.

DISC - The Domestic International Sales Corporation (DISC) has been judged to be an illegal export subsidy by the GATT. There has been no convincing evidence that DISC has contributed to increased U.S. exports but the program is a significant drain on government tax revenues. The Department of State urges the abolition of DISC.

Sub-Federal Taxes - Domestic corporations receive tax credits for income taxes paid to foreign sub-national governments but receive only deductions for income taxes paid to state and local jurisdictions in the United States. We understand that Treasury is considering treating some portion of foreign taxes paid to all foreign governments as an analogue to U.S. state and local taxes. This percentage would be used as a deduction, the remainder as a tax credit. The Department of State could support this approach if the percentage corresponded to the average split between federal and non-federal taxes now paid by domestic corporations.

The Honorable
W. Michael Blumenthal,
Secretary of the Treasury.

Integration of the Corporate and Personal Tax Systems - If the United States adopts tax integration, the Department of State would advocate that foreign income should be accounted as the last increment of income so that, in most cases, the value of the foreign tax credit not be lost to the U.S. corporation and that the United States should negotiate, in the context of tax treaties, reciprocal tax credits.

Section 911, private workers overseas - To eliminate the adverse impact of the 1976 tax law changes and still prevent unjustified avoidance of U.S. tax, the Department of State urges that changes in Section 911 along the following lines be made this year:

- (a) deductions for the following extraordinary expenses:
 - (1) housing expenses which exceed 15 percent of salary. Salary should be defined to exclude allowances or expenses which would themselves be deductible under this section.
 - (2) education expenses for tuition and travel (two round trips per year) up to \$5,000 per child through the twelfth grade (or equivalent) and for travel only through undergraduate university study.
 - (3) travel expenses for one round-trip home leave or R&R (from hardship posts only) per year for all family members.
 - (4) cost-of-living allowances or expenses where justified.
- (b) an option for the taxpayer to exclude the last \$15,000 of his foreign source earned income instead of taking the specific deductions.

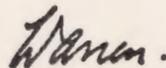
Section 912, government employees overseas - We have examined the implications of substituting Assistant Secretary Woodworth's proposed Section 911 for the present Section 912. The impact would be less severe than that of earlier proposals but would still adversely affect all government agencies with employees serving overseas. The Department of State's position, therefore, remains that expressed by Secretary Vance in his letter of July 30, opposing any change in Section 912.

The proposed changes would substantially increase the tax liability of government employees serving abroad. Private companies can compensate their employees for this increased liability but the U.S. Government cannot. Therefore, the proposals would impose additional financial burdens directly on government employees. This burden would be particularly great at posts where housing costs are high or where educational facilities are inadequate. Staffing these posts, an already hard task, would become extremely difficult. The result would be a lowering of the caliber of individuals we are able to attract to government service and a decrease in the efficiency of our overseas operations.

Moving Expenses - For moves between foreign countries or between the United States and a foreign country, the time limit on deductions for temporary housing costs should be increased from 30 days to 60 days and the dollar limits should be raised to twice the limits on domestic moves.

Foreign Convention Deductions - The 1976 Tax Reform Act limited the deductions U.S. taxpayers could take for expenses incurred at business-related conventions held outside the United States. Similar restrictions are not applied to business conventions held in the United States. The Department of State continues to oppose this discriminatory treatment as a violation of our international pledges to avoid trade and travel restrictions. We understand that Treasury is considering eliminating the provisions of present law which allow the taxpayer to deduct expenses at up to two foreign-site conventions per year. We object to such a proposal which would increase the discrimination between U.S. and foreign sites. We would support proposals (a) to permit normal deductions if the foreign site of the convention is reasonable because of the organization's large foreign membership or other specific reasons for holding the meeting at a certain site and (b) to raise the daily expense allowance. Further, we would recommend that the reasonableness test and limitations on deductions be applied uniformly to both domestic- and foreign-site conventions in order to eliminate the discriminatory aspect of the present law.

Sincerely,



Warren Christopher
Acting Secretary

Memorandum

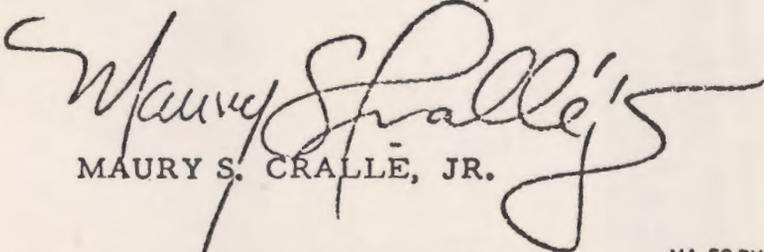
DATE: August 30, 1977

TO: Chief Benefits Director (20)
General Counsel (02)
Controller (04)

FROM: Assistant Deputy Administrator (003)

SUBJ: Memo for the Record

1. On Friday, 26 August at 1:30 the undersigned met with Mr. Donald C. Lubick, the Deputy Assistant Secretary for Tax Policy, Department of Treasury. A list of attendees of both Treasury and the Veterans Administration is attached.
2. The principal subject under discussion was the revision of the tax code to exclude certain portions of funds received for scholarships and fellowships. Treasury is considering a revision which would allow elimination from income that portion of the benefits received which was used for tuition and fees. The portion which would be used by the individual for normal living expenses would henceforth be treated as income. Treasury made the comment that because of other proposals and raised exemptions a married person with two children would be exempt if his income was less than \$10,000. Therefore, they felt that most of our clients would be exempted regardless of the change in the code that they are proposing.
3. We pointed out that there were numerous programs which provided educational benefits, i. e., full time, part time, tuition and fees, work study, etc.
4. Treasury has asked, and we have agreed to provide information in three general categories: (1) a description of the benefits provided, (2) experienced data in the use of the benefits to date, (3) our projection of the use of these benefits in the future. We agreed to furnish these three separate sets of information in as rapid a manner as possible and not to hold up any one set while waiting for data on other sets.
5. In addition, we pointed out to Treasury that there would not be a large monetary benefit to the nation from this change in the tax policy. We also pointed out that there might be certain consequences simply by making a proposal. We referred to a move currently afoot to separate the benefits into one for tuition and one for living expenses. The VA is currently resisting this proposal.


MAURY S. CRALLE, JR.



THE WHITE HOUSE
WASHINGTON

September 23, 1977

Zbig Brzezinski

The attached was returned in the President's outbox today and is forwarded to you for your information and appropriate handling. Please also forward a copy to Secretary Vance.

Rick Hutcheson

cc: Hamilton Jordan
Frank Moore

RE: SENATOR JACKSON LETTER ON STRATEGIC
ARMS LIMITATION TALKS

ADMINISTRATIVELY CONFIDENTIAL

THE WHITE HOUSE
WASHINGTON

*Admin
compil*

	FOR STAFFING
	FOR INFORMATION
✓	FROM PRESIDENT'S OUTBOX
	LOG IN/TO PRESIDENT TODAY
	IMMEDIATE TURNAROUND

cc VANCE
VIA 253

ACTION	FYI	
		MONDALE
		COSTANZA
		EIZENSTAT
	✓	JORDAN
		LIPSHUTZ
	✓	MOORE
		POWELL
		WATSON
		LANCE
		SCHULTZE

	ENROLLED BILL
	AGENCY REPORT
	CAB DECISION
	EXECUTIVE ORDER

Comments due to
Carp/Huron within
48 hours; due to
Staff Secretary
next day

	ARAGON
	BOURNE
✓	BRZEZINSKI
	BUTLER
	CARP
	H. CARTER
	CLOUGH
	FALLOWS
	FIRST LADY
	HARDEN
	HUTCHESON
	JAGODA
	KING

	KRAFT
	LINDER
	MITCHELL
	MOE
	PETERSON
	PETTIGREW
	POSTON
	PRESS
	SCHLESINGER
	SCHNEIDERS
	STRAUSS
	VOORDE
	WARREN

HENRY M. JACKSON
WASHINGTON

ROOM 137
RUSSELL SENATE OFFICE BUILDING
WASHINGTON, D.C. 20510

United States Senate

WASHINGTON, D.C.

September 22, 1977

PERSONAL AND CONFIDENTIAL

The President
The White House
Washington, D. C.

cc Cy
3619
for reply
JC

Dear Mr. President:

Within the last 24 hours I have been informed of the Administration's plans with respect to the conduct of the Strategic Arms Limitation Talks and the continuation after October 3 of the provisions of the 1972 Interim Agreement that limit the armaments of the United States. On both these matters I am profoundly troubled.

First, resort to a unilateral statement to the effect that we will continue the limitations on the armaments of the United States contained in the 1972 Interim Agreement would circumvent the statutory and constitutional responsibility of the Congress (or the Senate) to approve such actions. Section 33 of the Arms Control and Disarmament Act, reinforced by the history of that legislation, is clear on this point; and while a lawyer can doubtless be found to prepare arguments to the contrary, I do not believe that the Congress should, or would, acquiesce in permitting an action to be taken that limits the armaments of the United States without the approval of the Congress. In the strongest terms I urge you to submit to the Congress for its approval whatever policy declaration embodies a pledge to continue to respect the limitations of the Interim Agreement.

Second, I am increasingly alarmed at the deterioration of the Administration's negotiating position since your original March initiatives. The proposals of March have now been abandoned as U. S. negotiators have made concession after concession; while the Soviets have conceded nothing of substance. I was appalled to learn, for example, that the U. S. negotiators are prepared to agree that a 601 kilometer ground-based cruise missile armed with a conventional warhead will be outlawed under the protocol, whereas a Soviet ballistic missile with several MIRVed warheads carrying nuclear weapons over 4,000 kilometers will be totally unconstrained. The implications for the NATO alliance of so manifestly unbalanced a provision, (which, by the way, is totally unverifiable) are serious and damaging. I can see no justification for the inclusion in SALT of any conventional munitions or of non-strategic nuclear weapons.

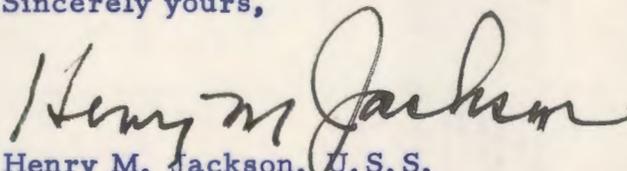
Jay 12/29/89

September 22, 1977

The premise of the SALT II negotiations has been that the U. S. would be prepared to make concessions in order to limit the evolving Soviet ICBM and SLBM threat while assuring that our bomber forces were adequately protected. U. S. negotiators seem now to have abandoned virtually all the meaningful constraints on the growth of the Soviet ICBM and SLBM forces. Moreover, by agreeing to limit to 2500 kilometers the permitted range of air-launched cruise missiles on our bomber force the United States runs a very serious risk of leaving itself without an operationally effective strategic bomber force as Soviet air defenses, which are in no way limited by SALT, continue to improve. The 2500 kilometer limitation, which the technical evidence indicates is dangerous and imprudent, raises serious questions about your claim that the cruise missile will be an effective alternative to the cancelled B-1 program.

Finally, I can only express my disappointment at the failure of your senior officials to consult with the Congress prior to deciding upon, and presenting to the Soviets, this most recent round of concessions, and by the decision to circumvent the established procedures for Congressional approval under our laws and Constitution.

Sincerely yours,



Henry M. Jackson, U. S. S.

THE SECRETARY OF STATE
WASHINGTON

September 21, 1977

Dear Mr. Chairman:

As you know, we have been exploring for some time ways in which we can facilitate an early and successful conclusion of the SALT II negotiations. One aspect of this subject which State and ACDA staffs have discussed with you is the situation that will exist after the present Interim SALT Agreement expires on October 3. In this regard, we have been considering a policy declaration expressing our intention, while the negotiations are being completed, not to take any action that would be inconsistent with the Interim Agreement's provisions, or with the goals of the ongoing negotiations, provided that the Soviet Union exercises similar restraint. Under this proposal, although the Soviets may also issue a statement of their policy in this regard, along the same lines, there would be no agreement limiting strategic offensive arms in force between the United States and the Soviet Union after October 3 and pending the conclusion of a new SALT Agreement.

Our objective is to maintain the status quo while the SALT II negotiations are being completed, and to complete the work on a SALT II Agreement within the near future. We do not seek to enter into a new agreement extending SALT I during this period, by an "exchange" of statements or otherwise. Accordingly, we have informed the Soviets that we intend to issue a unilateral policy declaration along the following lines:

The Honorable

John J. Sparkman, Chairman,
Committee on Foreign Relations,
United States Senate.

The Secretary of State requests the White House Congressional Liaison to contact the following Senators:

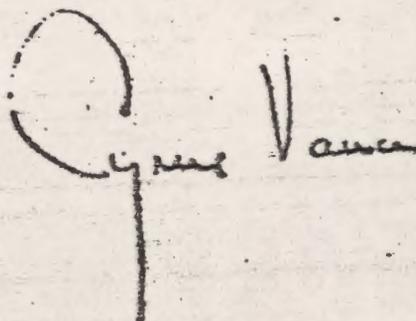
Tip O'Neill	Clifford Case
Alan Cranston	John Stennis
Robert Byrd	

In order to maintain the status quo while [SALT II] negotiations are being completed, the United States declares its intention not to take any action inconsistent with the provisions of the Interim Agreement on Certain Measures With Respect to the Limitation of Strategic Offensive Arms which expires October 3, 1977, and with the goals of these on-going negotiations, provided that the Soviet Union exercises similar restraint.

In considering how to proceed in this matter, we considered and rejected the possibility of a joint U.S.-Soviet statement which might have raised the question of whether an international agreement was intended. We do not intend to enter into an agreement and believe that our proposal is consistent with this intent, in substance as well as in form.

As indicated in our discussions with you and with the Committee staff, it is our desire to proceed in this matter in close consultation with the Congress. We fully recognize your committee's responsibilities with regard to international agreements generally and SALT II in particular. We hope you share our assessment that our discussions of this subject have been most helpful and constructive.

Sincerely,

A handwritten signature in dark ink, appearing to read "Cyrus Vance". The signature is written in a cursive style with a large, looped initial "C".