The original documents are located in Box 35, folder "Taxes (5)" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

[1976]

PRESIDENTIAL STATEMENT

Last October, three months before the tax cuts which had been temporarily enacted for 1975 were due to expire, I urged an extension and an expansion of these cuts for 1976 and subsequent years, coupled with a spending plan which would achieve a balanced budget in three years. The essence of my proposal was to permit you, the people, to decide how your money should be spent rather than having the Federal government make these decisions for you.

Last fall, the Congress fussed and fumed about tax cuts and spending and delayed any action until the last days of their session in December. They then submitted to me an unacceptable bill, which I vetoed.

Following the veto, the Congress responded with a bill which provided for a six-month extension of the 1975 tax cut and the Congress adopted the principle that any extended or expanded future tax cuts should be coupled with cuts in Federal spending.

Now it is five months later and Congress is once again getting around to considering what to do about your taxes which will automatically increase on July 1 unless they act before that date. This is an unfortunate repeat performance of the brinksmanship approach which Congress has been taking to tax legislation.

This is not to say that Congress has been idle with respect to the subject of tax legislation during the past five months. Indeed, they have labored long and hard on a tax reform bill which will be the subject of considerable debate and negotiation before it reaches my desk.

With regard to the most basic issue of tax cuts, however, Congress has tentatively decided not to provide the additional $10 billion in annual tax cuts which I have recommended. Instead, they have decided that they would rather spend this money themselves and have, accordingly, tentatively adopted a spending target for the next fiscal year of $413.3 billion, which is $17 billion more than I recommended in my budget for that fiscal year.

As I did last October, I urge you to support my clearly stated positions on increasing the tax cuts, effective July 1, and on curbing spending so that these cuts will not further increase the Federal deficit. It is not too late to accomplish these important tasks.

File

QUESTION: THE TREASURY DEPARTMENT ESTIMATES THAT THE PRESIDENT'S PROPOSAL TO INCREASE THE ESTATE TAX EXEMPTION TO $150,000 WILL REDUCE FEDERAL REVENUES $1.1 TO $1.2 BILLION WHEN FULLY EFFECTIVE. OTHER SOURCES SUGGEST THE REVENUE COST WILL BE MUCH HIGHER, PERHAPS TWICE AS MUCH. HOW DO YOU EXPLAIN THIS DIFFERENCE?

ANSWER : IN ORDER TO PROVIDE THE BROADEST POSSIBLE RELIEF AT THE LOWEST POSSIBLE REVENUE COST, THE PRESIDENT IS PROPOSING THAT THE LOWER RATE BRACKETS ON THE FIRST $90,000 OF TAXABLE ESTATE BE ELIMINATED. OTHER PROPOSALS ASSUME THAT THESE LOWER BRACKETS WILL BE RETAINED, SO THAT IN EFFECT THE EXISTING RATE SCHEDULE WOULD BE PUSHED UP.

IN EFFECT, UNDER THE PRESIDENT'S PROPOSAL THE INCREASED EXEMPTION IS TAKEN OUT OF THE LOWEST RATE BRACKETS FOR ALL ESTATES. THUS, THE PRESIDENT'S PROPOSAL WOULD ELIMINATE TAX ENTIRELY FOR ALL ESTATES WITH A TAXABLE ESTATE OF $150,000 OR LESS. LARGER ESTATES WOULD ALL RECEIVE APPROXIMATELY THE SAME TAX REDUCTION, ABOUT $17,900..

UNDER OTHER PROPOSALS THE INCREASED EXEMPTION WOULD BE TAKEN OUT OF EACH PARTICULAR ESTATE'S HIGHEST MARGINAL TAX BRACKET. THIS WOULD MEAN GREATER TAX BREAKS FOR LARGER ESTATES (UP TO A MAXIMUM OF $69,000) AND AN INCREASED REVENUE LOSS (ABOUT $1.6 BILLION FOR INCREASING THE EXEMPTION TO $150,000).

FURTHER INFO : THE EXACT TAX CUT UNDER THE PRESIDENT'S PROPOSAL WOULD VARY SLIGHTLY FROM ESTATE TO ESTATE BECAUSE OF SMALL CHANGES IN THE HIGHER ESTATE TAX RATES NEEDED TO PROVIDE A SMOOTH RATE PROGRESSION.

A TABLE SHOWING THE PRESENT LAW RATES AND THE PROPOSED RATES IS ATTACHED.

FOR 1973 RETURNS, THE LATEST YEAR FOR WHICH DATA IS AVAILABLE, A $150,000 EXEMPTION WOULD HAVE ELIMINATED TAX FOR 83,000 RETURNS; OR ABOUT 69 PERCENT OF THE 121,000 TAXABLE RETURNS FILED IN 1973.

Dale S. Collinson

DALE S. COLLINSON
X8024
528-9113
MARCH 8, 1976

TABLE

Present Tax Brackets	Present Estate Tax Rates (Percent)	Proposed Estate Tax Rate Structure	Proposed Estate Tax Rates (Percent)
Taxable net estate:			
0 to $5,000	3		
$5,000 to $10,000	7		
$10,000 to $20,000	11		
$20,000 to $30,000	14		
$30,000 to $40,000	18		
$40,000 to $50,000	22		
$50,000 to $60,000	25		
$60,000 to $100,000	28	$0 to $100,000 1/	30 1/
$100,000 to $250,000	30	$100,000 to $250,000	32
$250,000 to $500,000	32	$250,000 to $500,000	35
$500,000 to $750,000	35	$500,000 to $750,000	37
$750,000 to $1,000,000	37	$750,000 to $1,000,000	39
$1,000,000 to $1,250,000	39	$1,000,000 to $1,250,000	42
$1,250,000 to $1,500,000	42	$1,250,000 to $1,500,000	45
$1,500,000 to $2,000,000	45	$1,500,000 to $2,000,000	48
$2,000,000 to $2,500,000	49	$2,000,000 to $2,500,000	51
$2,500,000 to $3,000,000	53	$2,500,000 to $3,000,000	54
$3,000,000 to $3,500,000	56	$3,000,000 to $3,500,000	57
$3,500,000 to $4,000,000	59	$3,500,000 to $4,000,000	60
$4,000,000 to $5,000,000	63	$4,000,000 to $5,000,000	63
$5,000,000 to $6,000,000	67	$5,000,000 to $6,000,000	67
$6,000,000 to $7,000,000	70	$6,000,000 to $7,000,000	70
$7,000,000 to $8,000,000	73	$7,000,000 to $8,000,000	73
$8,000,000 to $10,000,000	76	$8,000,000 to $10,000,000	76
$10,000,000 and over	77	$10,000,000 and over	77

1/ Increasing the exemption from $60,000 to $150,000 eliminates tax on the first $90,000 of present law taxable estate. Thus, the new $0 to $100,000 bracket corresponds to the last $10,000 of the present law $60,000 to $100,000 bracket (presently taxable at 28%) and the first $90,000 of the present law $100,000 to $250,000 bracket (presently taxable at 30%). There would be similar overlaps for other brackets. The proposed schedule generally has the effect of eliminating the lower tax brackets up to $90,000.

QUESTION: Does the President's proposal to increase the estate exemption to $150,000 apply to all estates, or just to family farms and businesses?

ANSWER : The $150,000 exemption would be available to all estates.

FURTHER INFO : The President has separately proposed additional relief for family farms and businesses through a liberalization of the existing provisions for payment of estate tax in installments over 10 years. Under that proposal, there would be a 5 year moratorium during which no payments would be required. At the end of the 5 year period the estate tax could be paid over 20 years at a reduced (4 percent) rate of interest. This should permit the payment of estate taxes out of the earnings of the farm or business.

Dale S. Collinson

Dale S. Collinson
x8024
528-9113
March 8, 1976

QUESTION: WHAT IS THE IMPACT ON THE FISCAL 1976 AND FISCAL 1977 BUDGETS OF THE PRESIDENT'S PROPOSAL TO INCREASE THE ESTATE TAX EXEMPTION TO $150,000?

ANSWER : THERE IS NO IMPACT ON THE 1976 BUDGET OR THE TRANSITIONAL QUARTER BUDGET. WE ESTIMATE THAT THE REDUCTION IN RECEIPTS FOR FISCAL YEAR 1977 WOULD BE LESS THAN $100 MILLION.

FURTHER INFO : THE INCREASED EXEMPTION WOULD BE PHASED IN OVER FIVE YEARS BY INCREASING THE EXEMPTION $18,000 EACH YEAR AND ELIMINATING THE CORRESPONDING RATE BRACKETS. THE FIRST FULL YEAR REDUCTION IN LIABILITIES IS ESTIMATED TO BE $155 MILLION. HOWEVER, THE PROVISION WOULD APPLY ONLY TO ESTATES OF PERSONS DYING AFTER ITS ENACTMENT, AND ESTATE TAX RETURNS ARE GENERALLY NOT FILED UNTIL NINE MONTHS AFTER A PERSON'S DEATH. ASSUMING ENACTMENT OCCURS ON JULY 1, 1976, AFFECTED RETURNS WOULD FIRST BEGIN TO BE FILED APRIL 1, 1977, AND THERE WOULD BE ONLY A SIX MONTHS IMPACT ON RECEIPTS IN FY 1977.

Dale S. Collinson

DALE S. COLLINSON
x8024
528-9113
MARCH 8, 1976

QUESTION: FOR HOW MANY ESTATES WOULD ESTATE TAX LIABILITY BE ELIMINATED IF THE PRESIDENT'S PROPOSED $150,000 ESTATE TAX EXEMPTION IS ADOPTED?

ANSWER : OF THE ESTATES FILING RETURNS IN 1973, THE MOST RECENT YEAR FOR WHICH DATA IS AVAILABLE, 121,000 ESTATES HAD AN ESTATE TAX LIABILITY. THE $150,000 ESTATE TAX EXEMPTION WOULD HAVE ELIMINATED ESTATE TAX LIABILITY FOR 83,000 OF THOSE ESTATES, OR ABOUT 69 PERCENT.

Dale S. Collinson

DALE S. COLLINSON
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528-9113
MARCH 8, 1976

QUESTION: WILL THE ADMINISTRATION BE PRESENTING OTHER ESTATE AND GIFT TAX PROPOSALS?

ANSWER : PAST STUDIES OF THE ESTATE AND GIFT TAXES HAVE CONSIDERED A NUMBER OF MAJOR PROBLEM AREAS. THESE INCLUDE TAXATION OF UNREALIZED GAINS IN PROPERTY TRANSFERRED AT DEATH, LIBERALIZATION OF THE MARITAL DEDUCTION, UNIFICATION OF ESTATE AND GIFT TAXES, TAXATION OF GENERATION-SKIPPING TRUSTS, RATES AND EXEMPTIONS, AND RELIEF PROVISIONS FOR ILLIQUID ESTATES.

THE PRESIDENT HAS ANNOUNCED PROPOSALS TO INCREASE THE ESTATE TAX EXEMPTION AND TO PROVIDE LIBERAL PAYMENT PROVISIONS FOR THE ESTATE TAX ON FAMILY FARMS AND BUSINESSES.

THE ADMINISTRATION'S POSITION ON THE OTHER MAJOR ISSUES OF ESTATE AND GIFT TAX REFORM ARE STILL UNDER CONSIDERATION AND WILL BE PRESENTED IN TESTIMONY BEFORE THE WAYS AND MEANS COMMITTEE ON MARCH 22.

Dale S. Collinson

DALE S. COLLINSON
x8024
528-9113
MARCH 8, 1976

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

March 30, 1976

MEMORANDUM FOR THE HONORABLE L. WILLIAM SEIDMAN
ASSISTANT TO THE PRESIDENT FOR
ECONOMIC AFFAIRS

Subject: The President's 1976 Tax Program - Legislative Status

At your request, this memorandum will briefly outline the present status of the various tax proposals contained in the President's State of the Union Message and his subsequent speech on estate taxes.

Deepened Tax Cuts - Secretary Simon urged the adoption of the President's tax cut proposals in his testimony before the Senate Finance Committee on March 17, 1976. In their reports to the Budget Committees, both the Ways and Means Committee and the Senate Finance Committee assumed that the tax cut in effect during the first six months of 1976 would be extended at the same levels throughout fiscal 1977. In his report to the House Budget Committee, Chairman Brock Adams also recommended that the tax cut be extended at the same level throughout fiscal 1977. It seems quite likely that this is the course which Congress will in fact follow with the principal open points being: (i) the form of the cuts - i.e., present law versus an increased personal exemption and/or flat standard deduction; and (ii) the period of the tax cut extension - i.e., through calendar 1977 or permanent. The Administration must decide whether an $18 billion tax cut for fiscal 1977 would be acceptable if the expenditure limitation in the budget for that year exceeds $405 billion (i.e., the figure comparable to a $395 billion budget, with a $28 billion tax cut).

Broadened Stock Ownership Plan - Secretary Simon urged this plan upon the Senate Finance Committee on March 17, 1976. In private discussions with Senator Long and the Joint Committee Staff, we have received some encouragement that the Senator would support the BSOP plan if we supported his present concept of an Employee Stock Ownership Plan (ESOP) - i.e., one that is limited to the utility industry and funded by an increased investment credit. We have continued to refrain from disclosing publicly all details of the BSOP as we wish first to seek agreement with Senator Long and the Finance Committee. Secretary Simon will raise this issue when he meets with the Senator on April 9.

Job Creation Incentive - Most of the Republican members of the Ways and Means Committee joined in introducing H.R. 11854 on February 10, 1976, but Chairman Ullman has not scheduled hearings on this bill. Secretary Simon, of course, urged the adoption of the Job Creation Incentive program in his testimony on March 17, 1976. Several members of Congress, both Republican and Democrat, have introduced bills designed to deal with this problem. To date, the Finance Committee has not signalled whether it is seriously interested in considering this legislative initiative.

Increasing the Estate Tax Exemption to $150,000; Unlimited Estate and Gift Tax Exemption for Interspousal Transfers - Secretary Simon briefly mentioned these proposals in his appearance before the Finance Committee, and Assistant Secretary Walker presented the Secretary's detailed testimony in support of these proposals to the Ways and Means Committee on March 22, 1976. We will introduce this testimony into the record of the Senate Finance Committee as well. Both of the tax-writing Committees have taken testimony on the estate tax exemption, and it seems likely that some action (perhaps a credit approach) will be forthcoming this year. On the other hand, Congressional action on interspousal transfers and estate and gift tax "reform" issues this year seems unlikely due to political and time constraints.

Estate Tax Relief for Family Farms and Businesses - This proposal was presented in both the Finance Committee and the Ways and Means Committee testimony. Many Congressmen have introduced similar proposals, most of which are broader in scope. There is a substantial possibility that some action in this area will be taken in combination with the proposal to increase the estate tax exemption.

Social Security Tax Increase - The Senate Finance Committee made a tentative decision not to follow this Presidential recommendation this year, and the Ways and Means Committee budget recommendations assumed no such tax increase. It, thus, does not appear likely that the Budget Committees will recommend an increase in the Social Security tax for fiscal 1977. The Tax Policy office had not had direct responsibility for this particular legislative initiative.

Electric Utility Package - This proposal is, of course, part of the $28 billion tax cut package but it has been singled out for separate consideration. Secretary Simon once again urged the Finance Committee to adopt this proposal. There are some indications that Senator Long is interested in supporting this package, but combined with an Employee Stock Ownership Plan.

Integration of Corporate and Personal Income Taxes - This Administration initiative, first proposed by Secretary Simon in July 1975, was once again urged by him before the Senate Finance Committee on March 17, 1976. The Task Force of the Ways and Means Committee on Capital Formation is also giving serious attention to the subject of integration. It does not seem likely, however, that any Congressional action will be taken this year. Since our proposal is not to take effect until fiscal 1978, in any event, Congress could act next year without distorting our time table.

Tax Reform and the Curbing of Tax Shelters - H.R. 10612, as passed by the House, incorporates the limitation on artificial accounting losses and a modified minimum tax on tax preferences. In his testimony before the Senate Finance Committee, Secretary Simon again supported the limitation on artificial accounting losses but urged its modification to exclude any impact on oil and gas operations. He also urged the substitution of an alternative tax on minimum taxable income for the modified minimum tax on tax preferences. There are strong indications that the Senate Finance Committee will go along with some version of the minimum taxable income approach, but it also seems likely that it will not support any version of the limitation on artificial accounting losses. On the Senate floor, there will undoubtedly be considerable support for LAL from Senator Kennedy and others and a heated debate on minimum tax versus minimum taxable income. Thus, at this point, it is very difficult to predict the ultimate action to be taken by Congress this year on the tax reform proposals which the Administration first urged in 1973.

William M. Goldstein

William M. Goldstein
Deputy Assistant Secretary
for Tax Policy

EXECUTIVE CORRESPONDENCE

THE WHITE HOUSE

WASHINGTON

Jul 4

OTE

Dear Mr. Tell:

This will acknowledge your September 15 letter expressing concern over the anti-boycott provisions of the Export Administration Act and the Tax Reform Act.

~~As you know, the President signed the Tax Reform Act into law notwithstanding some specific concerns over several provisions~~. As you are probably aware, the Congress adjourned without acting on the Export Administration Act.

We appreciate having your views in this matter and find your assessment of the impact of legislation of this type to be very helpful.

Sincerely,

L. William Seidman
Assistant to the President
for Economic Affairs

Mr. William K. Tell, Jr.
Vice President
Texaco, Inc.
1050 Seventeenth Street, N.W.
Washington, D.C. 20036

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RETURN IT WITH THE FILE COPIES TO ORIGINATING OFFICE

THE WHITE HOUSE

WASHINGTON

September 17, 1976

TO: JIM CANNON

FROM: JOHN O. MARSH, JR. Jack

__________ For Direct Reply

_____X_____ For Draft Response

__________ For Your Information

__________ Please Advise

TEXACO

INC.

1050 SEVENTEENTH STREET, N.W.
WASHINGTON, D.C. 20036

WILLIAM K. TELL, JR.
VICE PRESIDENT

September 15, 1976

Mr. John O. Marsh, Jr.
Executive Office of the President
The White House Office
1600 Pennsylvania Avenue, N.W.
Washington, D. C. 20500

Dear Mr. Marsh:

As you are aware, Congress is currently considering legislation that contains anti-boycott provisions, e.g., the Export Administration Act, H.R. 15377, and the Tax Reform Act of 1976, H.R. 10612. As indicated in the attached statement released yesterday, Texaco is greatly concerned that such provisions are counter-productive in that they have every prospect of creating serious repercussions on the U.S. economy and damage to the U. S. interests in the Middle East.

Texaco does not believe that sufficient consideration has been given to the detrimental effects which such measures would have on our country.

I urge that you do whatever is possible to discourage passage of these counter-productive measures until there has been an opportunity for more careful evaluation and analysis of their impact.

Respectfully,

William K. Tell

WKT:jk
Att.

D

TEXACO

September 14, 1976

In response to media inquiries regarding Texaco's position on anti-boycott legislation presently pending in Congress, a Texaco spokesman made the following statement:

"Texaco believes the current Congressional efforts to legislate anti-boycott measures are not in the best interests of the country. The proposed legislation is counter-productive in that it has every prospect of creating serious repercussions on the U.S. economy and damage to U.S. interests in the Middle East without serving the purpose of eliminating the Arab boycott of Israel.

"The proposed Bingham anti-boycott amendment to the Export Administration Act Amendments of 1976 and the proposed Ribicoff amendment to the Tax Reform Act of 1976 would impose severe sanctions on U.S. firms which comply with formalities of the boycott. The effect of this legislation would be to impair the ability of U.S. firms to export to the Arab States, thereby bringing about a reduction in exports to the multi-billion dollar Middle East market, and a corresponding increase in domestic unemployment. U.S. exports to the Middle East would be replaced by those from other industrialized countries. This will reduce available foreign exchange needed to pay for the increasing imports of crude oil from the Middle East countries.

The bills' proponents fail to recognize that American firms doing business in the Mideast are in no position to alter the policies of the Arab States; the Arab boycott of Israel is a political problem the resolution of which requires the exercise of skillful diplomacy directed toward a just settlement of the entire Arab-Israeli conflict. Existing laws already on the books provide sufficient protection to U.S. firms or individuals who might be subjected to discrimination as a result of boycotts; additional anti-boycott legislation would have no effect on the underlying conflicts between the Arab States and Israel, may result in counter-measures by the Arab States including hardening the boycott, and may jeopardize U. S. Government peace initiatives in the Middle East.

The Ribicoff Amendment would use the tax code as a punitive device to attempt to carry out a foreign policy objective. This is a very questionable precedent which has not had the attention or consideration it deserves."

It was stated further by Texaco spokesman that "the Company strongly supports free trade with a minimum of restrictions and the Company opposes discrimination with respect to race, color, religion, sex, nationality or national origin."

TEXACO INC.
1050 SEVENTEENTH STREET, N. W.
WASHINGTON, D. C. 20036

Mr. John O. Marsh, Jr.
Executive Office of the President
The White House Office
1600 Pennsylvania Avenue, N.W.
Washington, D. C. 20500

WHITE HOUSE
POST # B-1

SEP 15 1976

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DOMESTIC COUNCIL CORRESPONDENCE PROFILE

DOC MO	DOC DA	RECD MO	RECD DA	RECD HR	LOG NBR
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SOURCE/DESCRIPTION

TO: PRES
V.P.
CANNON
DUNHAM
CAVANAUGH
EX. SEC
OTHER Marsh, Jack

FROM: CANNON
DUNHAM
CAVANAUGH
WHSS
OTHER Tell, Wm

REFERENCE:
WHSS
OTHER

INITIAL ACTION OFFICER Leach

SPECIAL CODE

SUBJECT: Wm Tell, Vice-Pres of TEXACO, Inc expresses concern over the Export Administration Act HR-15377, & the Tax Reform Act of 1976, HR-10612

LEAD DEPT/AGENCY:

DISTR/INITIAL ACTION ASSIGNMENT

INTERNAL ROUTING AND DISTRIBUTION	ACTION		REC CY FOR
ADVANCE CYS TO JMC			
DEPUTY DIR - POLICY AND RG			
DEPUTY DIR - OPERATIONS			
STAFF SECRETARY			
HEALTH, SOC SCTY AND PUB. ASST.			
CRIME, JUSTICE, CIVIL RTS, AND COMM.			
HOUSING AND COMMT'Y AFFAIRS			
ENVIRONMENT			
AGRIC, ECON DEV AND COMMERCE	✓		
LABOR, EDUC, AND VETERANS			
ENERGY AND TRANSPORTATION			
GENERAL GOVERNMENT			
INTERGOVERNMENTAL RELATIONS			
EXECUTIVE SECRETARIAT			

ACTION REQUIRED
MEMO FOR PRES .... ( )
MEMO FOR JMC .... ( )
REPLY FOR .... ( )
APPROPRIATE ACTION .... (✓)
ANY ACTION NECESSARY? .... ( )
MEMO: FROM ______ TO: ______ ( )
JOINT MEMO .... ( )
REFER TO: ______ ( )
FOR: ______ ( )
CONCURRENCE........................ ( )
______ .... ( )

COMMENTS: (INCLUDING SPECIAL INSTRUCTIONS)

DUE

DATES
DUE: Oct 14 5 AM/PM LDA ______ AM/PM

SUBSEQUENT ROUTING/ACTIONS

DATE	FROM	TO	S	SUBSEQUENT ACTION REQUIRED (OR TAKEN).	CY TO

EXEC SEC DISP INSTR

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THE WHITE HOUSE

WASHINGTON

1976 NOV 23 PM 5 06

November 22, 1976

Bill Seidman
FYI.
Jim

MEMORANDUM FOR: JIM LYNN
JIM CANNON

FROM: JEANNE HOLM

SUBJECT: President's Tax Reform Proposal

It is my understanding that the President intends to submit a tax proposal to the Congress in January.

Last year the President recommended the elimination of the estate and gift tax on transfers of assets between spouses. In the Tax Reform Act of 1976, Congress did not fully adopt his recommendation. On October 15, the President said that he would re-submit this recommendation to the next Congress.

Farm wives and other women's organizations, including the President's National Commission on the Observance of International Women's Year, have made similar suggestions. Their lobbying efforts will be continued during the next Congress.

Thus, I recommend the re-submission of this proposal as a part of the President's tax reform package.

JMC

THE WHITE HOUSE

WASHINGTON

December 6, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEMBERS

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: Basic Tax Reform Report

A paper, prepared by the Treasury, summarizing the Basic Tax Reform Preliminary Report is attached. This paper will be reviewed at the Tuesday, December 7, 1976 Executive Committee meeting.

Due to the sensitive nature of the material in the paper, I would appreciate you keeping its distribution strictly limited.

Attachment

Summary of Preliminary BTR Report

I. Overview

The report presents two proposals for broad-based reform of the individual and corporate income taxes. The proposals embody practical applications of two different conceptions of ideal tax systems. In so doing, they show how the tax system can be made simpler, more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy within a framework that permits maintenance of the vertical progressivity of the current rate structure.

Development of the plans for radical tax reform were motivated in part by the widespread dissatisfaction with the current tax system. In particular, criticisms of the current system have focussed on the appropriateness of current provisions on what items belong in the tax base. Numerous special features of the current law, relating both favorably and adversely to different sources and uses of income, introduce complexity into the system and raise questions about its fairness. In addition, many provisions of the code provide subsidies for special industries and for some forms of investment and consumption which are rarely justified explicitly and which may, in some cases, be unintentional. These subsidies, in many instances, tend to alter the pattern of economic activity in ways which may lower the social value of total output produced in the private sector. Further, although broadly speaking the present Federal tax system relates tax burdens to individual ability to pay, many details of the tax code do not reflect any consistent philosophy about the objectives of the system. The resulting confusion and complexity in the current tax code has led Secretary Simon to suggest that we should "have a tax system which looks like someone designed it on purpose."

Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are

maintained in the proposals, they are identified explicitly as such and justification is provided. The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax.

Both proposals cover all of the major individual areas where changes from the current tax code merit consideration. In all cases where there are ambiguities about defining either the consumption or change in wealth components of income or where social values embodied in exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made in the report for the purpose of presenting complete proposals. The report identifies those features of the proposal which are essential for definition of the ideal tax base, distinguishing them from the parts of the proposal which can legitimately be handled in different ways and still remain consistent with a reasonable definition of either the accretion or consumption ideal.

The report shows that it is feasible to have a broad-based tax reform which departs in major ways from the current tax law. By providing two specific alternative plans -- even if preliminary -- it sets out a guide for possible future tax legislation aimed at sweeping reform, and also points out some of the main issues which remain to be resolved where social policy judgment, ultimately based on political and other considerations, must supplement technical analysis. Finally, in presenting a plan for a tax system based on the consumption ideal, the report points towards a promising alternative approach to tax reform which merits strong consideration.

II. Comprehensive Income Tax (Accretion Base)

Adoption of a more comprehensive definition of income in the tax base has received the most attention from reformers.

Income is defined by tax specialists as the sum of consumption and change in net worth in a given time period. Though income is defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases

of consumer goods and the change in value of all the items on his balance sheet. Rather, income is measured by using the simple accounting concept that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is simply necessary to subtract from sources some expenditures which represent neither consumption nor additions to net worth. These expenditures for an individual include costs of operating his business (payment of salaries, rent, interest, etc.). They may also include direct costs of earning labor income (union dues, work clothing, etc), and perhaps some other expenditures such as interest, charitable contributions, State and local income, and sales taxes. For some items, e.g., large non-discretionary medical expenditures, there is some ambiguity as to whether or not they should be regarded as consumption and included in income (i.e., not deductible).

The tax base under current law departs from an ideal comprehensive tax base both in its measurement of sources of receipts and in its exclusion of some uses. Examples of the former are the exclusion of State and local bond interest and the double taxation of dividends of corporations. Examples of the latter include tax depreciation schedules which do not approximate actual changes in asset values, inclusion of only one-half of realized capital gains in the tax base and deferral of unrealized gains, and deductions for some types of consumption expenditures.

The comprehensive income tax proposal sets out a practical plan designed to approximate an accretion base as closely as possible. The major features of the comprehensive income tax are:

. <u>integration of the corporate and personal income taxes</u>

A separate tax on corporations does not fit into the ideal of a comprehensive tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income can ultimately be accounted for either as consumption or an increase in the value of claims of individuals who own corporate shares. The burden of the corporation income tax falls on individuals, but in ways which are difficult to determine. These burdens are almost certainly not systematically related to individual ability to pay.

Under the comprehensive income tax proposal the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Corporate distributions to shareholders are not separately taxed, but are treated as a reduction in basis.

The proposal contians a set of rules for allocating corporate income to individuals which are practically effective and come close to measuring annual income earned by shareholders as it accrues.

The advantages of integration are that 1) it ends the incentive to accumulate income within corporations by ending the double taxation of dividends, 2) it enables the effective tax rate on income earned within corporations to be keyed to the circumstances of individual taxpayers, and 3) it provides a practical method for accrual taxation of capital gains. Capital gains which result from retianed earnings of corporations are automatically taxed under the proposal as they accrue, although capital gains resulting from changed expectations are only taxed when assets are sold.

. treatment of capital gains

Under an ideal comprehensive tax base, capital gains which represent an increase in real wealth should be taxed even though not realized by sale or exchange of the asset. The proposal moves in that direction by adopting the integration concept, and by advocating taxation of captial gains, though only upon realization, at full rates and allowing a step-up in basis for inflation. Thus, the proposal, while ending the current provision for exclusion of one-half of capital gains from the base, will also end the taxation of purely inflationary gains. Compared to present law, taxation of capital gains would be lower during periods of rapid inflation and higher during periods of relative price stability. The proposal does not recommend taxation of gains as accrued, i.e. prior to realization, because of the administrative cost of annual asset valuations. Thus, the tax benefits from deferring realization of capital gains are retained. However, the corporate integration proposal does enable a major fraction of individual income which was previously reflected in realized capital gain to be taxed as it accrues.

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The proposal defines some generalprinciples for measuring depreciation of assets for tax purposes. It is recommended that ADR be made mandatory for machinery and equipment. New rules for calculating depreciation are recommended for structures. Cost depletion is recommended in place of percentage depletion for mineral deposits.

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The proposal recommends that interest from state and local bonds be included in the computation of the tax base on the grounds that those receipts can be used for consumption or increases in net worth as well as receipts from any other source. The report mentions some alternative and less costly ways of providing the same subsidy to state and local governments as is presently provided by the interest exemption if such subsidization is viewed to be socially desirable.

. imputed income from consumer durables

Under an ideal comprehensive tax base, the imputed return in the form of the rental value of consumption services from ownership of consumer durables would be taxed. The exclusion of imputed income from tax provides an especially large subsidy to owner-occupied homes. This proposal does not recommend taxation of the imputed interest from homes and consumer durables, both because of difficulties of measurement and because the subsidization of home ownership appears to be a valid social policy. However, it is recommended that the deductibility of local taxes on personal property, including homes, be ended.

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The report recommends revisions in treatment of major deductions, including deductions for medical expenses (replace with a catastrophic insurance program), charitable contributions (continue the deduction), state and local sales and income taxes (deductible), and casualty losses (will be eliminated in revision of the report). The major issues in deciding whether, and in what form, major personal deductions should be maintained concern whether or not a particular item of expenditure should be viewed as consumption and whether or not particular types of economic activities ought to be subsidized. While the report sets up

specific proposals for treatment of all of these categories, it is noted that other rules are also consistent with the general ideal of a comprehensive income base. The deduction of interest is maintained, as is, in modified form, the deduction of child care expenses. The report recommends elimination of the standard deduction.

. <u>retirement income</u>

Under a comprehensive income tax, both contributions to retirement pensions and the interest earned on such contributions should be included in the base. However, a roughly equivalent result is achieved by taxing retirement income and currently accrued earnings on pension funds and allowing employer <u>and</u> employee contributions to pensions to be deducted from the tax base. This procedure is preferable because it minimizes income averaging problems. Rules for making different types of pension accounts conform to this principle are outlined in the report. In contrast, social security taxes are not viewed as a purchase of a retirement annuity because of the looser connection between contributions made and retirement benefits received. For social security, it is proposed to allow deduction of both employee and employer contributions and to include all social security retirement income in the tax base.

The proposal also recommends that unemployment compensation payments be included in the tax base.

. <u>choice of a filing unit and exemptions for family size</u>

The report recommends family filing with rate brackets slightly less than twice as wide as the brackets for individual taxpayers. The decision on the appropriate filing unit represents a compromise between two objectives which cannot be met simultaneously when the rate structure is progressive: a system in which families with equal size with equal incomes should pay equal taxes and a system in which the total tax liability of two individuals is not altered when they marry. To reduce the work disincentive features caused by taxation of secondary earners at marginal rates to determine the income of a spouse, the plan also proposes that only 75 percent of the first $10,000 of earnings of secondary workers be included in the tax base. Alternative possible treatments of the filing unit which are also consistent with the general principles of an accretion base are presented.

The report discusses the issues in the choice between exemptions and tax credits for family size, and recommends a per-member exemption. Again alternative methods of adjusting for family size described in the report may also be viewed as consistent with the accretion base.

In summary, the comprehensive income tax proposal is a complete plan for radical alteration of the tax system which eliminates many of the inconsistencies of the present law. Some provisions of the plan fall short of the accretion ideal because of practical considerations. However, the plan demonstrates the feasibility of major improvements in the simplicity,efficiency,and fairness in the income tax.

III. Cash Flow, Consumption Based Tax

A cash flow, or consumption base tax, is less widely advocated in discussions of tax reform but deserves serious consideration as an alternative ideal for the tax base. The cash flow tax differs from the comprehensive income tax by excluding changes in net worth from the tax base. In practical terms, this means that net saving, as well as gifts and current purchases which are not regarded as consumption, are subtracted from gross receipts to compute the tax base.

The report shows that a cash flow tax has a number of advantages over a comprehensive income tax on simplicity grounds. A cash flow tax avoids the most difficult problems of measurement under a comprehensive income tax, such as depreciation rules, inflation adjustment, allocation of undistributed corporate income, and measurement of unrelaized capital gains. These can be avoided because changes in net worth are not included in the tax base. In addition, the report demonstrates that the cash flow tax is more equitable because, unlike a comprehensive income tax, it treats individuals beginning their working years with equal wealth and the same present value of future labor earnings the same. They are treated differently under an income tax, depending on the time pattern of their earnings and the way they choose to allocate consumption expenditures among time periods. The cash flow tax, by eliminating disincentives to savings by taxing consumption, would encourage capital formation, leading to higher growth rates in the short-run and more capital per worker and higher before-tax wages in the long-run.

The report also points out that the current tax system, though riddled with inconsistencies, is in many ways closer to a cash flow tax than a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans--home-ownership and employer contributions to retirement annuities (or contributions of individuals to Keogh Plans and IRA's)--are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

One way of designing a cash flow tax is to have an individual compute his tax base by including all monetary receipts in a given time period in the tax base and subtracting purchases of assets, itemized gifts, and certain itemized expenditures also allowed as deductions under the comprehensive income tax. In the plan presented in this report purchases of assets are eligible for deduction only if made through qualified accounts and interest and dividends earned outside of qualified accounts would not be taxed. Each year net contributions (withdrawals) to (from) qualified accounts would be computed and subtracting from (added to) the individual's tax base. Thus, the proceeds from an investment made through a qualified account would be subject to tax <u>only when withdrawn for the purpose of consumption</u>.

Savings not deposited in a qualified account would not be eligible for deductions but the interest and capital gains from investments financed by such saving would not be included in the tax base. The report shows that pre-payment of taxes on savings combined with exclusion of capital income from tax is in an important sense equivalent to deductibility of savings and inclusion of principal and interest in the tax base upon withdrawal for consumption. The two alternative ways of treating assets do not alter the present value of the tax base; deferral of tax in the present leads to payment of the same tax plus interest at the time the asset is sold for consumption. However, inclusion of a part of income in the tax base can be delayed by purchasing a qualified asset.

The report spells out the consequences of allowing a taxpayer to choose at will between two alternative ways of being taxed on income from assets, providing specific examples of how the tax would work. It is shown how allowing two alternative treatments for both assets and loans provides a simple device for the taxpayer to average the tax base over a number of years, thus avoiding the inequities associated

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Under the proposal, all consumer durables would be treated as tax prepaid assets. No deductions would be allowed for the purchase of a consumer durable and receipts from the sale of a consumer durable would not be included in the tax base.

Gifts would be treated differently under the cash flow tax than under both the comprehensive income tax and the current tax system. In the cash flow tax proposal, gifts and inheritances received are included in the tax base while gifts given are deducted. It is assumed that the cash flow tax would be supplemented by a separate tax on transfers of assets by gift or bequest.

The proposal describes in detail how specific items of capital income, including dividends, interest, capital gains, income from personal business, and accumulation of retirement pensions would be treated in accordance with the principles outlined above. The corporate income tax would be eliminated because there would no longer be a need to tax undistributed corporate income. Purchases of corporate stocks through qualified accounts would be tax deductible while all withdrawals from qualified accounts would be included in the tax base. Sale proceeds of corporate stock, dividends, and interest, if remaining in the qulaified account, would not be taxed.

The cash flow tax, like the comprehensive income tax, would move towards neutrality in the tax treatment of different kinds of investments. By doing this, both proposals would have the effect of encouraging the best use of available capital. In addition, however, the cash flow tax eliminates the discouragement to capital formation inherent in the accretion concept.

The cash flow tax proposal treats definition of the filing unit, exemptions for family size, and deductions of personal consumption items the same way as the comprehensive income tax proposal. The only differences between the two

proposals are the difference in the treatment of items which represent a change in net worth, and the difference in the treatment of gifts and inheritances.

IV. Transition Problems

Reforming the existing tax system poses a different set of problems than designing a new tax system from scratch. While the report concentrates on the design of approximations to ideal tax systems, the problems of transition have also been examined and embodied in specific proposals.

Transition to a new set of tax rules poses two separate, but related problems. First, changes in rules for taxing income from capital will lead to changes in relative asset values. Problems of fairness exist when investors who have purchased a particular type of asset in light of the present tax system would be subjected to losses by rapid and major changes in tax policy. Similarly, changes in tax policy may provide some investors with windfall gains. Second, changes in the tax law raise questions of what to do about income earned before the effective date, but not yet subject to tax. For example, the comprehensive income tax, which proposes full inclusion of capital gains in the base, requires a transiton rule for taxing capital gains accumulated before, but realized after the effective date.

The report outlines a series of specific transition proposals for handling income earned before the effective date, but not yet taxed. It also describes two methods for moderating the wealth effects of tax reform--"grandfathering", or exempting existing assets from the new tax provisions and phasing-in the new rules. Specific proposals for use of these instruments for different projected changes in the tax code are presented. The report also presents a transition proposal for phasing-in a cash flow tax.

Transition will be a major problem in any significant reform of the tax system. The analysis of transition issues, and the rules proposed for specific changes in the code in this report can be applicable to a number of alternative plans for future changes in the tax system.

V. How An Individual Would Calculate Tax Liability Under the Reform Plans

The method of calculation of tax liabilities under the broad-based reform plans is basically similar to the method under the current personal income tax. A form similar to a Form 1040 with boxes indicating family status and number of exemptions will be filled out. There will, however, be no standard deduction under either plan; any taxpayer with any positive amounts of eligible deductions would choose to itemize. To reduce the number of itemizers generally deductions would be subject to floor amounts.

Taxable income would be calculated on the form, and the relevant tax rate schedule, determined by the status of the filing unit (i.e., single, married, head of household), would be applied to taxable income to compute tax liability. Taxes owed, or refunds due, would depend on the difference between tax liability and taxes withheld as reported on W-2 statements.

The wages and salaries of the primary wage-earner would remain the biggest item in computing taxable income of most households and would be entered into the calculation of income the same way as under the current system.

Some items in the computation of tax would change under both reform plans. The first $10,000 of wages and salaries of secondary wage-earners in any family would be multiplied by .75 before being added into the computation of taxable income. The rules for calculating some deductions (e.g., child care) would be changed and other deductions (e.g., property and gasoline taxes) would be eliminated.

Under the comprehensive income tax, some additional items would be added to the computation of taxable income. Corporations would supply to all stockholders a statement giving the amount of profit attributed to that stockholder in the previous year, and an adjustment to basis which would rise with earnings and fall with distributions. (The integration proposal includes procedures for handling changes in shareholders during the year and audit adjustments to the corporation's income.) Similar statements of attributions of earnings would be supplied by pension funds and insurance companies. The individual would include the income reported in those statements in his computation of taxable income. Also, interest income from state and local bonds, unemployment compensation, and social security retirement income would be included in the computation of taxable income.

All capital gains (or losses) would be entered in full in the computation of taxable income. In computing capital gains, the individaul would be allowed to adjust his basis for inflation. A table of allowable percentage basis adjustments would be provided in the tax form. In addition, the individual would use statements received from corporations to adjust his basis upward for corporate profits attributed to him and downward for distributions received.

The major change under the cash-flow tax is that the taxpayer would receive each year statements from all of his qualified accounts on net withdrawals or deposits in the previous year. The source of an individual's deposits to qualified accounts are current savings and past accumulated capital and the source of withdrawals are past deposits and interest, capital gains, and dividends received on investments made through the qualified accounts. Net withdrawals from (positive) and deposits to (negative) all qualified accounts would be shown on a separate form and the sum would be added to, if positive, or subtracted from, if negative other items included in the computation of taxable income.

Interest, dividends, and capital gains realized on investments made outside of qualified accounts would not be reported on the tax form and would not be included in taxable income. Deductions would not be allowed for interest paid on loans outside of qualified accounts.

Gifts and inheritances received would be included in taxable income (but if deposited in a qualified account would have an offsetting deduction), and separate lines will be provided for them on the tax form. A deduction would be allowed for gifts given. On the form for itemized deductions, the identity of the recipient of all deductible gifts and his social security number would be recorded.

VI. Chapter-by-Chapter Outline of Tax Reform Report

Chapter 1--Introduction

Chapter 1 sets out the objectives of a reformed tax system: equity, efficiency, and simplicity. The scope of the study is defined to include only the Federal income tax and the corporation tax. The relationship of the income and corporation taxes to other taxes in the system, notably the payroll tax, and to means-tested grant programs is briefly explored. The content of the remainder of the report is outlined.

Chapter 2--What is to be the Tax Base?

Chapter 2 reviews the main issues in choosing an appropriate tax base, and presents the case for considering a cash flow tax based on consumption as a serious alternative to a reformed comprehensive income tax. General issues of equity in design of a tax system are discussed and the concepts of consumption and income are explained in detail. It is shown that the current tax system contains some elements of a consumption base and some elements of a comprehensive income base. The alternative tax bases are then compared on the grounds of equity, simplicity, and effects on economic efficiency.

Chapter 3--A Model Comprehensive Income Tax

A plan for a model comprehensive income tax is presented in Chapter 3. The major innovations in the plan relate to integration of the corporation and personal income taxes, tax treatment of capital gains, treatment of State and local bond interest, taxation of income accumulated in pensions and life insurance funds, and treatment of retirement income and unemployment compensation. Suggested changes in many personal deductions are presented, and are related to the concept of income. Important recommendations for changes in the filing unit, adjustment for family size, and taxation of secondary wage earners are set forth. International considerations in income taxation are briefly discussed. The Chapter concludes with a description of a sample form for an individual's tax calculation under the comprehensive income tax.

Chapter 4--A Model Cash Flow Tax

In Chapter 4, a plan for a model cash flow tax based on consumption is presented. The major innovation in the cash-flow tax is that savings may be deducted from the tax base. A plan for using the device of qualified accounts to measure the flow of saving and consumption is presented. The equivalence between deductibility of saving and exclusion of capital earnings from tax is explained, and a plan for alternative treatment of assets following from this equivalence is presented. Treatment of specific items under the model cash flow tax is proposed in detail, and compared with treatment of the corresponding items under the comprehensive income tax. Arguments against the cash-flow tax on grounds of progressivity and effect on the wealth distribution are evaluated, and the possible use of a supplementary wealth transfer tax is explored. The Chapter concludes with a description of a sample individual tax form under the cash flow tax.

Chapter 5--Transition Rules Under Basic Tax Reform

Chapter 5 proposes a set of transition rules to accompany introduction of each one of the model tax plans. Problems which may arise in changing tax laws are explained, and some instruments to ameliorate adjustment problems, including exempting existing assets from the tax change and phasing-in the new rules, are described and evaluated. Specific proposals are presented for transition to both a comprehensive income base and a cash flow base which cover the timing of the application of the new rules to specific proposed changes in the tax code.

Chapter 6--Quantitative Analyses

Chapter 6 presents preliminary simulations of the effects of adoption of the proposed model tax reform plans on the tax liability of different groups of taxpayers. The Chapter includes examples of how taxpayers in different categories would calculate their taxes under the model plans.

Dec 7-8, 1976

TAX file

Summary of Preliminary BTR Report

I. Overview

The report presents two proposals for broad-based reform of the individual and corporate income taxes. The proposals embody practical applications of two different conceptions of ideal tax systems. In so doing, they show how the tax system can be made simpler, more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy within a framework that permits maintenance of the vertical progressivity of the current rate structure.

Development of the plans for radical tax reform were motivated in part by the widespread dissatisfaction with the current tax system. In particular, criticisms of the current system have focussed on the appropriateness of current provisions on what items belong in the tax base. Numerous special features of the current law, relating both favorably and adversely to different sources and uses of income, introduce complexity into the system and raise questions about its fairness. In addition, many provisions of the code provide subsidies for special industries and for some forms of investment and consumption which are rarely justified explicitly and which may, in some cases, be unintentional. These subsidies, in many instances, tend to alter the pattern of economic activity in ways which may lower the social value of total output produced in the private sector. Further, although broadly speaking the present Federal tax system relates tax burdens to individual ability to pay, many details of the tax code do not reflect any consistent philosophy about the objectives of the system. The resulting confusion and complexity in the current tax code has led Secretary Simon to suggest that we should "have a tax system which looks like someone designed it on purpose."

Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are

maintained in the proposals, they are identified explicitly as such and justification is provided. The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax.

Both proposals cover all of the major individual areas where changes from the current tax code merit consideration. In all cases where there are ambiguities about defining either the consumption or change in wealth components of income or where social values embodied in exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made in the report for the purpose of presenting complete proposals. The report identifies those features of the proposal which are essential for definition of the ideal tax base, distinguishing them from the parts of the proposal which can legitimately be handled in different ways and still remain consistent with a reasonable definition of either the accretion or consumption ideal.

The report shows that it is feasible to have a broad-based tax reform which departs in major ways from the current tax law. By providing two specific alternative plans -- even if preliminary -- it sets out a guide for possible future tax legislation aimed at sweeping reform, and also points out some of the main issues which remain to be resolved where social policy judgment, ultimately based on political and other considerations, must supplement technical analysis. Finally, in presenting a plan for a tax system based on the consumption ideal, the report points towards a promising alternative approach to tax reform which merits strong consideration.

II. Comprehensive Income Tax (Accretion Base)

Adoption of a more comprehensive definition of income in the tax base has received the most attention from reformers.

Income is defined by tax specialists as the sum of consumption and change in net worth in a given time period. Though income is defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases

of consumer goods and the change in value of all the items on his balance sheet. Rather, income is measured by using the simple accounting concept that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is simply necessary to subtract from sources some expenditures which represent neither consumption nor additions to net worth. These expenditures for an individual include costs of operating his business (payment of salaries, rent, interest, etc.). They may also include direct costs of earning labor income (union dues, work clothing, etc), and perhaps some other expenditures such as interest, charitable contributions, State and local income, and sales taxes. For some items, e.g., large non-discretionary medical expenditures, there is some ambiguity as to whether or not they should be regarded as consumption and included in income (i.e., not deductible).

The tax base under current law departs from an ideal comprehensive tax base both in its measurement of sources of receipts and in its exclusion of some uses. Examples of the former are the exclusion of State and local bond interest and the double taxation of dividends of corporations. Examples of the latter include tax depreciation schedules which do not approximate actual changes in asset values, inclusion of only one-half of realized capital gains in the tax base and deferral of unrealized gains, and deductions for some types of consumption expenditures.

The comprehensive income tax proposal sets out a practical plan designed to approximate an accretion base as closely as possible. The major features of the comprehensive income tax are:

. <u>integration of the corporate and personal income taxes</u>

A separate tax on corporations does not fit into the ideal of a comprehensive tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income can ultimately be accounted for either as consumption or an increase in the value of claims of individuals who own corporate shares. The burden of the corporation income tax falls on individuals, but in ways which are difficult to determine. These burdens are almost certainly not systematically related to individual ability to pay.

Under the comprehensive income tax proposal the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Corporate distributions to shareholders are not separately taxed, but are treated as a reduction in basis.

The proposal contians a set of rules for allocating corporate income to individuals which are practically effective and come close to measuring annual income earned by shareholders as it accrues.

The advantages of integration are that 1) it ends the incentive to accumulate income within corporations by ending the double taxation of dividends, 2) it enables the effective tax rate on income earned within corporations to be keyed to the circumstances of individual taxpayers, and 3) it provides a practical method for accrual taxation of capital gains. Capital gains which result from retianed earnings of corporations are automatically taxed under the proposal as they accrue, although capital gains resulting from changed expectations are only taxed when assets are sold.

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The proposal describes in detail how specific items of capital income, including dividends, interest, capital gains, income from personal business, and accumulation of retirement pensions would be treated in accordance with the principles outlined above. The corporate income tax would be eliminated because there would no longer be a need to tax undistributed corporate income. Purchases of corporate stocks through qualified accounts would be tax deductible while all withdrawals from qualified accounts would be included in the tax base. Sale proceeds of corporate stock, dividends, and interest, if remaining in the qulaified account, would not be taxed.

The cash flow tax, like the comprehensive income tax, would move towards neutrality in the tax treatment of different kinds of investments. By doing this, both proposals would have the effect of encouraging the best use of available capital. In addition, however, the cash flow tax eliminates the discouragement to capital formation inherent in the accretion concept.

The cash flow tax proposal treats definition of the filing unit, exemptions for family size, and deductions of personal consumption items the same way as the comprehensive income tax proposal. The only differences between the two

proposals are the difference in the treatment of items which represent a change in net worth, and the difference in the treatment of gifts and inheritances.

IV. Transition Problems

Reforming the existing tax system poses a different set of problems than designing a new tax system from scratch. While the report concentrates on the design of approximations to ideal tax systems, the problems of transition have also been examined and embodied in specific proposals.

Transition to a new set of tax rules poses two separate, but related problems. First, changes in rules for taxing income from capital will lead to changes in relative asset values. Problems of fairness exist when investors who have purchased a particular type of asset in light of the present tax system would be subjected to losses by rapid and major changes in tax policy. Similarly, changes in tax policy may provide some investors with windfall gains. Second, changes in the tax law raise questions of what to do about income earned before the effective date, but not yet subject to tax. For example, the comprehensive income tax, which proposes full inclusion of capital gains in the base, requires a transiton rule for taxing capital gains accumulated before, but realized after the effective date.

The report outlines a series of specific transition proposals for handling income earned before the effective date, but not yet taxed. It also describes two methods for moderating the wealth effects of tax reform--"grandfathering", or exempting existing assets from the new tax provisions and phasing-in the new rules. Specific proposals for use of these instruments for different projected changes in the tax code are presented. The report also presents a transition proposal for phasing-in a cash flow tax.

Transition will be a major problem in any significant reform of the tax system. The analysis of transition issues, and the rules proposed for specific changes in the code in this report can be applicable to a number of alternative plans for future changes in the tax system.

V. <u>How An Individual Would Calculate Tax Liability Under the Reform Plans</u>

The method of calculation of tax liabilities under the broad-based reform plans is basically similar to the method under the current personal income tax. A form similar to a Form 1040 with boxes indicating family status and number of exemptions will be filled out. There will, however, be no standard deduction under either plan; any taxpayer with any positive amounts of eligible deductions would choose to itemize. To reduce the number of itemizers generally deductions would be subject to floor amounts.

Taxable income would be calculated on the form, and the relevant tax rate schedule, determined by the status of the filing unit (<u>i.e.</u>, single, married, head of household), would be applied to taxable income to compute tax liability. Taxes owed, or refunds due, would depend on the difference between tax liability and taxes withheld as reported on W-2 statements.

The wages and salaries of the primary wage-earner would remain the biggest item in computing taxable income of most households and would be entered into the calculation of income the same way as under the current system.

Some items in the computation of tax would change under both reform plans. The first $10,000 of wages and salaries of <u>secondary</u> wage-earners in any family would be multiplied by .75 before being added into the computation of taxable income. The rules for calculating some deductions (<u>e.g.</u>, child care) would be changed and other deductions (<u>e.g.</u>, property and gasoline taxes) would be eliminated.

Under the comprehensive income tax, some additional items would be added to the computation of taxable income. Corporations would supply to all stockholders a statement giving the amount of profit attributed to that stockholder in the previous year, and an adjustment to basis which would rise with earnings and fall with distributions. (The integration proposal includes procedures for handling changes in shareholders during the year and audit adjustments to the corporation's income.) Similar statements of attributions of earnings would be supplied by pension funds and insurance companies. The individual would include the income reported in those statements in his computation of taxable income. Also, interest income from state and local bonds, unemployment compensation, and social security retirement income would be included in the computation of taxable income.

All capital gains (or losses) would be entered in full in the computation of taxable income. In computing capital gains, the individaul would be allowed to adjust his basis for inflation. A table of allowable percentage basis adjustments would be provided in the tax form. In addition, the individual would use statements received from corporations to adjust his basis upward for corporate profits attributed to him and downward for distributions received.

The major change under the cash-flow tax is that the taxpayer would receive each year statements from all of his qualified accounts on net withdrawals or deposits in the previous year. The source of an individual's deposits to qualified accounts are current savings and past accumulated capital and the source of withdrawals are past deposits and interest, capital gains, and dividends received on investments made through the qualified accounts. Net withdrawals from (positive) and deposits to (negative) all qualified accounts would be shown on a separate form and the sum would be added to, if positive, or subtracted from, if negative other items included in the computation of taxable income.

Interest, dividends, and capital gains realized on investments made outside of qualified accounts would not be reported on the tax form and would not be included in taxable income. Deductions would not be allowed for interest paid on loans outside of qualified accounts.

Gifts and inheritances received would be included in taxable income (but if deposited in a qualified account would have an offsetting deduction), and separate lines will be provided for them on the tax form. A deduction would be allowed for gifts given. On the form for itemized deductions, the identity of the recipient of all deductible gifts and his social security number would be recorded.

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Chapter 1--Introduction

Chapter 1 sets out the objectives of a reformed tax system: equity, efficiency, and simplicity. The scope of the study is defined to include only the Federal income tax and the corporation tax. The relationship of the income and corporation taxes to other taxes in the system, notably the payroll tax, and to means-tested grant programs is briefly explored. The content of the remainder of the report is outlined.

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Chapter 2 reviews the main issues in choosing an appropriate tax base, and presents the case for considering a cash flow tax based on consumption as a serious alternative to a reformed comprehensive income tax. General issues of equity in design of a tax system are discussed and the concepts of consumption and income are explained in detail. It is shown that the current tax system contains some elements of a consumption base and some elements of a comprehensive income base. The alternative tax bases are then compared on the grounds of equity, simplicity, and effects on economic efficiency.

Chapter 3--A Model Comprehensive Income Tax

A plan for a model comprehensive income tax is presented in Chapter 3. The major innovations in the plan relate to integration of the corporation and personal income taxes, tax treatment of capital gains, treatment of State and local bond interest, taxation of income accumulated in pensions and life insurance funds, and treatment of retirement income and unemployment compensation. Suggested changes in many personal deductions are presented, and are related to the concept of income. Important recommendations for changes in the filing unit, adjustment for family size, and taxation of secondary wage earners are set forth. International considerations in income taxation are briefly discussed. The Chapter concludes with a description of a sample form for an individual's tax calculation under the comprehensive income tax.

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FAB
Dec 7-8, 1976

Summary of Preliminary BTR Report

I. Overview

The report presents two proposals for broad-based reform of the individual and corporate income taxes. The proposals embody practical applications of two different conceptions of ideal tax systems. In so doing, they show how the tax system can be made simpler, more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy within a framework that permits maintenance of the vertical progressivity of the current rate structure.

Development of the plans for radical tax reform were motivated in part by the widespread dissatisfaction with the current tax system. In particular, criticisms of the current system have focussed on the appropriateness of current provisions on what items belong in the tax base. Numerous special features of the current law, relating both favorably and adversely to different sources and uses of income, introduce complexity into the system and raise questions about its fairness. In addition, many provisions of the code provide subsidies for special industries and for some forms of investment and consumption which are rarely justified explicitly and which may, in some cases, be unintentional. These subsidies, in many instances, tend to alter the pattern of economic activity in ways which may lower the social value of total output produced in the private sector. Further, although broadly speaking the present Federal tax system relates tax burdens to individual ability to pay, many details of the tax code do not reflect any consistent philosophy about the objectives of the system. The resulting confusion and complexity in the current tax code has led Secretary Simon to suggest that we should "have a tax system which looks like someone designed it on purpose."

Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are

maintained in the proposals, they are identified explicitly as such and justification is provided. The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax.

Both proposals cover all of the major individual areas where changes from the current tax code merit consideration. In all cases where there are ambiguities about defining either the consumption or change in wealth components of income or where social values embodied in exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made in the report for the purpose of presenting complete proposals. The report identifies those features of the proposal which are essential for definition of the ideal tax base, distinguishing them from the parts of the proposal which can legitimately be handled in different ways and still remain consistent with a reasonable definition of either the accretion or consumption ideal.

The report shows that it is feasible to have a broad-based tax reform which departs in major ways from the current tax law. By providing two specific alternative plans -- even if preliminary -- it sets out a guide for possible future tax legislation aimed at sweeping reform, and also points out some of the main issues which remain to be resolved where social policy judgment, ultimately based on political and other considerations, must supplement technical analysis. Finally, in presenting a plan for a tax system based on the consumption ideal, the report points towards a promising alternative approach to tax reform which merits strong consideration.

II. Comprehensive Income Tax (Accretion Base)

Adoption of a more comprehensive definition of income in the tax base has received the most attention from reformers.

Income is defined by tax specialists as the sum of consumption and change in net worth in a given time period. Though income is defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases

of consumer goods and the change in value of all the items on his balance sheet. Rather, income is measured by using the simple accounting concept that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is simply necessary to subtract from sources some expenditures which represent neither consumption nor additions to net worth. These expenditures for an individual include costs of operating his business (payment of salaries, rent, interest, etc.). They may also include direct costs of earning labor income (union dues, work clothing, etc), and perhaps some other expenditures such as interest, charitable contributions, State and local income, and sales taxes. For some items, e.g., large non-discretionary medical expenditures, there is some ambiguity as to whether or not they should be regarded as consumption and included in income (i.e., not deductible).

The tax base under current law departs from an ideal comprehensive tax base both in its measurement of sources of receipts and in its exclusion of some uses. Examples of the former are the exclusion of State and local bond interest and the double taxation of dividends of corporations. Examples of the latter include tax depreciation schedules which do not approximate actual changes in asset values, inclusion of only one-half of realized capital gains in the tax base and deferral of unrealized gains, and deductions for some types of consumption expenditures.

The comprehensive income tax proposal sets out a practical plan designed to approximate an accretion base as closely as possible. The major features of the comprehensive income tax are:

. <u>integration of the corporate and personal income taxes</u>

A separate tax on corporations does not fit into the ideal of a comprehensive tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income can ultimately be accounted for either as consumption or an increase in the value of claims of individuals who own corporate shares. The burden of the corporation income tax falls on individuals, but in ways which are difficult to determine. These burdens are almost certainly not systematically related to individual ability to pay.

Under the comprehensive income tax proposal the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Corporate distributions to shareholders are not separately taxed, but are treated as a reduction in basis.

The proposal contians a set of rules for allocating corporate income to individuals which are practically effective and come close to measuring annual income earned by shareholders as it accrues.

The advantages of integration are that 1) it ends the incentive to accumulate income within corporations by ending the double taxation of dividends, 2) it enables the effective tax rate on income earned within corporations to be keyed to the circumstances of individual taxpayers, and 3) it provides a practical method for accrual taxation of capital gains. Capital gains which result from retianed earnings of corporations are automatically taxed under the proposal as they accrue, although capital gains resulting from changed expectations are only taxed when assets are sold.

. treatment of capital gains

Under an ideal comprehensive tax base, capital gains which represent an increase in real wealth should be taxed even though not realized by sale or exchange of the asset. The proposal moves in that direction by adopting the integration concept, and by advocating taxation of captial gains, though only upon realization, at full rates and allowing a step-up in basis for inflation. Thus, the proposal, while ending the current provision for exclusion of one-half of capital gains from the base, will also end the taxation of purely inflationary gains. Compared to present law, taxation of capital gains would be lower during periods of rapid inflation and higher during periods of relative price stability. The proposal does not recommend taxation of gains as accrued, i.e. prior to realization, because of the administrative cost of annual asset valuations. Thus, the tax benefits from deferring realization of capital gains are retained. However, the corporate integration proposal does enable a major fraction of individual income which was previously reflected in realized capital gain to be taxed as it accrues.

. <u>depreciation rules</u>

The proposal defines some general principles for measuring depreciation of assets for tax purposes. It is recommended that ADR be made mandatory for machinery and equipment. New rules for calculating depreciation are recommended for structures. Cost depletion is recommended in place of percentage depletion for mineral deposits.

. <u>state and local bond interest</u>

The proposal recommends that interest from state and local bonds be included in the computation of the tax base on the grounds that those receipts can be used for consumption or increases in net worth as well as receipts from any other source. The report mentions some alternative and less costly ways of providing the same subsidy to state and local governments as is presently provided by the interest exemption if such subsidization is viewed to be socially desirable.

. <u>imputed income from consumer durables</u>

Under an ideal comprehensive tax base, the imputed return in the form of the rental value of consumption services from ownership of consumer durables would be taxed. The exclusion of imputed income from tax provides an especially large subsidy to owner-occupied homes. This proposal does <u>not</u> recommend taxation of the imputed interest from homes and consumer durables, both because of difficulties of measurement and because the subsidization of home ownership appears to be a valid social policy. However, it is recommended that the deductibility of local taxes on personal property, including homes, be ended.

. <u>itemized deductions</u>

The report recommends revisions in treatment of major deductions, including deductions for medical expenses (replace with a catastrophic insurance program), charitable contributions (continue the deduction), state and local sales and income taxes (deductible), and casualty losses (will be eliminated in revision of the report). The major issues in deciding whether, and in what form, major personal deductions should be maintained concern whether or not a particular item of expenditure should be viewed as consumption and whether or not particular types of economic activities ought to be subsidized. While the report sets up

specific proposals for treatment of all of these categories, it is noted that other rules are also consistent with the general ideal of a comprehensive income base. The deduction of interest is maintained, as is, in modified form, the deduction of child care expenses. The report recommends elimination of the standard deduction.

. retirement income

Under a comprehensive income tax, both contributions to retirement pensions and the interest earned on such contributions should be included in the base. However, a roughly equivalent result is achieved by taxing retirement income and currently accrued earnings on pension funds and allowing employer and employee contributions to pensions to be deducted from the tax base. This procedure is preferable because it minimizes income averaging problems. Rules for making different types of pension accounts conform to this principle are outlined in the report. In contrast, social security taxes are not viewed as a purchase of a retirement annuity because of the looser connection between contributions made and retirement benefits received. For social security, it is proposed to allow deduction of both employee and employer contributions and to include all social security retirement income in the tax base.

The proposal also recommends that unemployment compensation payments be included in the tax base.

. choice of a filing unit and exemptions for family size

The report recommends family filing with rate brackets slightly less than twice as wide as the brackets for individual taxpayers. The decision on the appropriate filing unit represents a compromise between two objectives which cannot be met simultaneously when the rate structure is progressive: a system in which families with equal size with equal incomes should pay equal taxes and a system in which the total tax liability of two individuals is not altered when they marry. To reduce the work disincentive features caused by taxation of secondary earners at marginal rates to determine the income of a spouse, the plan also proposes that only 75 percent of the first $10,000 of earnings of secondary workers be included in the tax base. Alternative possible treatments of the filing unit which are also consistent with the general principles of an accretion base are presented.

The report discusses the issues in the choice between exemptions and tax credits for family size, and recommends a per-member exemption. Again alternative methods of adjusting for family size described in the report may also be viewed as consistent with the accretion base.

In summary, the comprehensive income tax proposal is a complete plan for radical alteration of the tax system which eliminates many of the inconsistencies of the present law. Some provisions of the plan fall short of the accretion ideal because of practical considerations. However, the plan demonstrates the feasibility of major improvements in the simplicity, efficiency, and fairness in the income tax.

III. Cash Flow, Consumption Based Tax

A cash flow, or consumption base tax, is less widely advocated in discussions of tax reform but deserves serious consideration as an alternative ideal for the tax base. The cash flow tax differs from the comprehensive income tax by excluding changes in net worth from the tax base. In practical terms, this means that net saving, as well as gifts and current purchases which are not regarded as consumption, are subtracted from gross receipts to compute the tax base.

The report shows that a cash flow tax has a number of advantages over a comprehensive income tax on simplicity grounds. A cash flow tax avoids the most difficult problems of measurement under a comprehensive income tax, such as depreciation rules, inflation adjustment, allocation of undistributed corporate income, and measurement of unrelaized capital gains. These can be avoided because changes in net worth are not included in the tax base. In addition, the report demonstrates that the cash flow tax is more equitable because, unlike a comprehensive income tax, it treats individuals beginning their working years with equal wealth and the same present value of future labor earnings the same. They are treated differently under an income tax, depending on the time pattern of their earnings and the way they choose to allocate consumption expenditures among time periods. The cash flow tax, by eliminating disincentives to savings by taxing consumption, would encourage capital formation, leading to higher growth rates in the short-run and more capital per worker and higher before-tax wages in the long-run.

The report also points out that the current tax system, though riddled with inconsistencies, is in many ways closer to a cash flow tax than a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans--home-ownership and employer contributions to retirement annuities (or contributions of individuals to Keogh Plans and IRA's)--are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

One way of designing a cash flow tax is to have an individual compute his tax base by including all monetary receipts in a given time period in the tax base and subtracting purchases of assets, itemized gifts, and certain itemized expenditures also allowed as deductions under the comprehensive income tax. In the plan presented in this report purchases of assets are eligible for deduction only if made through qualified accounts and interest and dividends earned outside of qualified accounts would not be taxed. Each year net contributions (withdrawals) to (from) qualified accounts would be computed and subtracting from (added to) the individual's tax base. Thus, the proceeds from an investment made through a qualified account would be subject to tax only when withdrawn for the purpose of consumption.

Savings not deposited in a qualified account would not be eligible for deductions but the interest and capital gains from investments financed by such saving would not be included in the tax base. The report shows that pre-payment of taxes on savings combined with exclusion of capital income from tax is in an important sense equivalent to deductibility of savings and inclusion of principal and interest in the tax base upon withdrawal for consumption. The two alternative ways of treating assets do not alter the present value of the tax base; deferral of tax in the present leads to payment of the same tax plus interest at the time the asset is sold for consumption. However, inclusion of a part of income in the tax base can be delayed by purchasing a qualified asset.

The report spells out the consequences of allowing a taxpayer to choose at will between two alternative ways of being taxed on income from assets, providing specific examples of how the tax would work. It is shown how allowing two alternative treatments for both assets and loans provides a simple device for the taxpayer to average the tax base over a number of years, thus avoiding the inequities associated

with applying a progressive rate system to individuals with different annual variation in the level of consumption expenditures. The report also shows how allowing alternative treatment of assets and loans simplifies the measurement of the tax base.

Under the proposal, all consumer durables would be treated as tax prepaid assets. No deductions would be allowed for the purchase of a consumer durable and receipts from the sale of a consumer durable would not be included in the tax base.

Gifts would be treated differently under the cash flow tax than under both the comprehensive income tax and the current tax system. In the cash flow tax proposal, gifts and inheritances received are included in the tax base while gifts given are deducted. It is assumed that the cash flow tax would be supplemented by a separate tax on transfers of assets by gift or bequest.

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THE WHITE HOUSE

WASHINGTON

December 8, 1976

MEMORANDUM FOR: JIM CANNON

FROM: PAUL LEACH

SUBJECT: Preliminary Tax Reform Report

This book length report is summarized at the beginning in a short paper which I recommend to you.

To summarize the summary, this report presents the broad tax reform proposals:

1. A comprehensive income tax, which provides for a broader definition of income (i.e., it includes many items of income and increases of net worth in the tax base which are not already included).

2. A cash flow, consumption - based tax, which differs from the comprehensive income tax by excluding most net worth changes from the tax base.

As the summary says: "The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax."