

TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH

The Treasury Department Report to the President

Volume 2 General Explanation of the
Treasury Department Proposals



Office of the Secretary
Department of the Treasury

November 1984

PREFACE

This volume contains general explanations of the Treasury Department proposals for fundamental tax reform. The general explanations are intended to provide additional information concerning the scope and operative effect of the Treasury Department proposals. Much of the information is detailed, but an attempt has been made to avoid overly technical description. Where possible, the general explanations include an analysis of the effects of the proposals on particular taxpayers and industries and on the economy as a whole.

The general explanations are not intended to and do not describe the full range of statutory changes that would be necessary to implement the Treasury Department proposals. Due to the breadth of the proposals, conforming changes would be necessary throughout the Internal Revenue Code. No attempt has been made to identify all such changes. In addition, subjecting the proposals to the scrutiny of the legislative process inevitably would unearth unexpected interactions that would, in turn, require modifications in particular proposals. That process is welcomed. The Treasury Department proposals can be implemented only through fair and orderly transition rules. While a general description of the proposed transition provisions is contained in this volume, the general explanations do not attempt to address all issues that would arise in the transition from current law to the tax system described in the Treasury Department proposals. Specifically, the movement toward a largely inflation-proof tax system would have a significant effect on existing and planned investments; effects that must be dealt with if the move is to be accomplished. Although the problems of transition are significant, they are technical in nature and capable of solution within the framework of the Treasury Department proposals.

TABLE OF CONTENTS

Volume Two

I. INDIVIDUAL INCOME TAXES

Chapter 1. <u>MARGINAL TAX RATES</u>	1
1.01 Reduce Marginal Tax Rates	1
Chapter 2. <u>FAIRNESS FOR FAMILIES</u>	4
2.01 Increase ZBA And Personal Exemptions	5
2.02 Combine Tax Benefits For Elderly, Blind, And Disabled Into Expanded Credit	9
2.03 Repeal Two-Earner Deduction	13
2.04 Index Earned Income Tax Credit	15
2.05 Replace Child And Dependent Care Credit With Deduction	17
Chapter 3. <u>FAIR AND NEUTRAL TAXATION</u>	20
Part A. <u>Excluded Sources Of Income--Fringe Benefits</u>	20
3.01 Limit Employer-Provided Health Insurance	23
3.02 Repeal Exclusion For Employer- Provided Group Term Life Insurance	29
3.03 Repeal \$5,000 Exclusion For Employer- Provided Death Benefits	31
3.04 Repeal Exclusion For Employer-Provided Legal Services	33
3.05 Repeal Exclusion For Employer-Provided Dependent Care Services	34
3.06 Repeal Exclusion For Employer-Provided Commuting Services	36
3.07 Repeal Exclusion For Employer-Provided Educational Assistance	37
3.08 Repeal Exclusion For Employer-Provided Cafeteria Plans	39
3.09 Repeal Special Treatment Of Incentive Stock Options	41
3.10 Repeal Tax-Exemption For VEBAs, SUB Trusts, And Black Lung Trusts	43
3.11 Repeal Exclusion For Employee Awards	45

3.12	Repeal Exclusion For Military Allowances	47
3.13	Repeal Exclusion For Parsonage Allowances	49
Part B.	<u>Excluded Sources Of Income--Wage Replacement Payments</u>	51
3.14	Repeal Exclusion For Unemployment And Disability Payments	51
Part C.	<u>Excluded Sources Of Income--Others</u>	58
3.15	Limit Scholarship And Fellowship Exclusion	58
3.16	Repeal Exclusion For Prizes And Awards	60
Part D.	<u>Preferred Uses Of Income</u>	61
3.17	Repeal Deduction Of State And Local Taxes	62
3.18	Impose Floor On Charitable Deductions	69
3.19	Limit Charitable Deduction For Appreciated Property	72
3.20	Revise Percentage Limitations On Charitable Deductions	75
3.21	Repeal Charitable Deduction For Nonitemizers	78
Part E.	<u>Tax Abuses--Mixed Business/Personal Use</u>	80
3.22	Limit Deduction For Entertainment And Business Meal Expenses	81
3.23	Limit Deduction For Travel Expenses	86
Part F.	<u>Tax Abuses--Income Shifting</u>	91
3.24	Adjust Tax Rate Of Unearned Income Of Minor Children	92
3.25	Revise Grantor And Non-Grantor Trust Taxation	96
3.26	Revise Income Taxation Of Estates	107
Chapter 4.	<u>SIMPLIFICATION</u>	110
4.01	Study Return-Free System	111
4.02	Repeal Alternative Minimum Tax	112
4.03	Impose Floor On Employee Business Expense And Miscellaneous Deductions	115
4.04	Repeal Political Contribution Credit	117

4.05	Repeal Presidential Campaign Check-Off	119
4.06	Repeal Adoption Expense Deduction	120
Chapter 5.	<u>OTHER MISCELLANEOUS REFORMS</u>	121
5.01	Increase Limits On Moving Expenses	122
5.02	Restrict Income Averaging For Full-Time Students	125
II.	<u>BUSINESS AND CAPITAL INCOME TAXES</u>	
Chapter 6.	<u>CORPORATE TAX RATES</u>	127
6.01	Reduce Corporate Income Tax Rates	128
6.02	Repeal Corporate Minimum Tax	130
Chapter 7.	<u>TAXATION OF BUSINESS ORGANIZATIONS</u>	133
7.01	Reduce Double Taxation Of Corporate Earnings Distributed To Shareholders	134
7.02	Repeal \$100/\$200 Dividend Income Exclusion	145
7.03	Tax Large Limited Partnerships As Corporations	146
Chapter 8.	<u>CAPITAL CONSUMPTION ALLOWANCES</u>	151
8.01	Index And Adjust Depreciation Schedules	152
8.02	Repeal Investment Tax Credit	173
Chapter 9.	<u>ADJUSTMENTS FOR EFFECTS OF INFLATION</u>	177
9.01	Index Capital Assets	178
9.02	Index Inventories	189
9.03	Index Indebtedness	193
Chapter 10.	<u>INCOME MEASUREMENT</u>	201
10.01	Revise Accounting Rules For Multiperiod Production	202
10.02	Treat Pledges Of Installment Obligations As Payments	212
10.03	Limit Use Of Cash Method Of Accounting	215
10.04	Repeal Reserve Method For Bad Debt Deductions	218

Chapter 11.	<u>TAXATION OF ENERGY AND NATURAL RESOURCES</u>	223
11.01	Repeal Energy Tax Credits	224
11.02	Repeal Percentage Depletion	229
11.03	Repeal Expensing Of Intangible Drilling Costs	232
11.04	Repeal Expensing Of Hard Mineral Exploration and Development Costs	234
11.05	Repeal Deduction For Qualified Tertiary Injectant Expenses	236
11.06	Revise Royalty Taxation	238
11.07	Repeal Mining And Solid Waste Reclamation And Closing Cost Deduction	240
11.08	Repeal Windfall Profit Tax	243
Chapter 12.	<u>FINANCIAL INSTITUTIONS</u>	245
Part A.	<u>Commercial Banks And Thrift Institutions</u>	245
12.01	Repeal Special Rules For Bank Bad Debt Deductions	246
12.02	Deny Deduction For Interest To Carry Tax-Exempt Bonds	249
12.03	Repeal Tax Exemption For Credit Unions	253
12.04	Repeal Reorganization Rules For Financially Troubled Thrift Institutions	255
Part B.	<u>Life Insurance Companies And Products</u>	257
12.05	Impose Current Taxation On Life Insurance Inside Interest Build-Up	258
12.06	Revise Taxation Of Policyholder Loans And Partial Withdrawals	263
12.07	Impose Current Taxation On Deferred Annuity Investment Income	266
12.08	Limit Life Insurance Company Reserve Deduction	268
12.09	Repeal Special Life Insurance Company Deductions	270
Part C.	<u>Property And Casualty Insurance Companies</u>	272
12.10	Limit Property And Casualty Insurance Company Reserve Deduction	273
12.11	Repeal Mutual Property And Casualty Insurance Company Protection Against Loss Account	280

12.12	Repeal Special Tax Exemptions, Rate Reductions, And Deductions Of Small Mutual Property And Casualty Insurance Companies	282
12.13	Limit Mutual Property And Casualty Insurance Company Deduction For Policyholder Dividends	284
Part D.	<u>Tax Exemption For Insurance Companies</u>	286
12.14	Repeal Tax Exemption For Certain Insurance Companies	286
Chapter 13.	<u>STATE AND LOCAL GOVERNMENT DEBT AND INVESTMENTS</u>	288
13.01	Repeal Tax Exemption For Nongovernmental Bonds	289
13.02	Limit Tax Arbitrage And Advance Refunding For Tax-Exempt Bonds	293
13.03	Repeal General Stock Ownership Corporation Provisions	298
Chapter 14.	<u>SPECIAL EXPENSING AND AMORTIZATION RULES</u>	299
14.01	Retain \$5,000 Limit On Expensing Depreciable Business Property	300
14.02	Repeal Rapid Amortization Rules	302
Chapter 15.	<u>OTHER SPECIFIC SUBSIDIES</u>	314
15.01	Repeal Tax Credit For Qualified Rehabilitation	315
15.02	Repeal Special Rules For Book, Magazine, And Discount Coupon Income	318
15.03	Extend And Modify Research And Experimentation Credit	321
15.04	Repeal Merchant Marine Capital Construction Fund Exclusion	324
15.05	Repeal Possessions Tax Credit	327
Chapter 16.	<u>OTHER CURTAILMENT OF TAX SHELTERS</u>	330
16.01	Limit Interest Deductions	331
16.02	Extend At-Risk Limitation To All Activities	334

Chapter 17.	<u>RETIREMENT SAVINGS</u>	336
17.01	Increase Individual Retirement Account (IRA) Limits	337
17.02	Unify Rules For Qualified Retirement Plan Distributions	339
17.03	Simplify Deduction Rules For Qualified Retirement Plans	345
17.04	Modify Annual Limits On Qualified Retirement Plan Contributions And Benefits	349
17.05	Impose Ten Percent Tax On Qualified Retirement Plan Assets Reverting To Employer	354
17.06	Repeal Cash Or Deferred Arrangement (CODA) Provisions	356
17.07	Modify Rules For Benefit Forfeitures	358

Chapter 18.	<u>INTERNATIONAL ISSUES</u>	359
18.01	Reform Foreign Tax Credit	360
18.02	Modify Sourcing Rules For Income And Deductions	364
18.03	Replace Second Dividend Tax With Branch Profits Tax	369
18.04	Impose Interest Treatment On Foreign Exchange Gains And Losses	371

III. OTHER TAX ISSUES

Chapter 19.	<u>TRANSFER TAXATION</u>	373
19.01	Unify Estate And Gift Tax Systems	374
19.02	Revise Power Of Appointment Rules	384
19.03	Revise Federal Gift Tax Property Value Determination	386
19.04	Simplify Generation-Skipping Transfer Tax	389
19.05	Expand Credit For Tax On Prior Transfers	393
19.06	Revise Rules For Installment Payment Of Estate Tax	395
19.07	Repeal Estate Tax Deduction For Interest Expense	398
19.08	Revise Income In Respect Of A Decedent Rules	400

19.09	Limit State Death Tax Credit	402
19.10	Repeal Capital Gain Treatment For Redemptions Of Stock To Pay Death Taxes	404
Chapter 20.	<u>PENALTIES</u>	406
20.01	Simplify Penalty Provisions	406