ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA

8:30 a.m.
Roosevelt Room

June 10, 1976

PRINCIPALS ONLY

1. Senate Finance Committee Tax Reform Bill — Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUN 9 1976

MEMORANDUM FOR: Economic Policy Board

FROM: Charles M. Walker
Assistant Secretary for Tax Policy

SUBJECT: Senate Finance Committee Tax Reform Bill

On Friday, June 4, 1976, the Senate Finance Committee reached decisions as to the effective dates of the various provisions of a tax reform bill it will report on June 9 or 10. Generally, the Committee selected January 1, 1976 as the effective date for the revenue-raising provisions and January 1, 1977 for the revenue-reducing provisions. The Committee will meet again on June 10 to consider additional amendments. Amendments adopted at that session will be reported out as "committee amendments" during the week of June 14 when the Senate floor debate is expected to begin.

This memorandum summarizes the principal provisions* of each title of the bill as of June 4 and sets forth the Office of Tax Policy recommendations with respect to each section of the bill. To the extent possible, we indicate the possible compromises in conference. The subject of the tax cuts was considered at a previous meeting of the Economic Policy Board and is not, therefore, discussed in this memorandum.

The fiscal year tax liabilities changes attributable to the tax reform program will reflect an increase of only $852 million in Fiscal Year 1977 and a decrease of $132 million in 1981. A major floor battle looms over the alleged disregard by the Finance Committee of the apparent mandate of the Concurrent Budget Resolution to raise an additional $2 billion from tax reform measures.

*These summaries are based on the press releases issued by the Finance Committee and the drafts of the bill and committee report we have reviewed to date. The drafting of both the bill and the report are continuing as of this writing.

TITLE I -- MINIMUM AND MAXIMUM TAXES

1. MINIMUM TAX

Description

The Finance Committee rejected the Administration's limitation on artificial accounting losses (LAL) proposal which had been accepted by the House. The Committee also rejected the Administration's minimum taxable income (MTI) proposal. MTI is an alternative tax concept designed to assure that taxpayers with high economic income pay their fair share of taxes. It had not been accepted by the House. To deal with the problems presented by tax shelters, the Finance Committee opted for a revision of the present law add-on minimum tax as follows:

-- Increase rate from 10 to 15 percent

-- Provide for an exemption of $5,000 or regular taxes paid if greater, but delete carryover of regular taxes paid

-- Retain present law items of tax preference

- o Accelerated depreciation on real property
- o Accelerated depreciation on personal property subject to a net lease
- o Excess of percentage depletion over basis
- o Excluded portion of long-term capital gains
- o Bargain element of qualified stock options

-- Add new items of tax preference

- o Real estate construction period interest
- o Accelerated depreciation on personal property subject to an operating lease
- o Excess of investment interest over investment income
- o Excess of itemized deductions (other than deductions for medical expenses and casualty losses) over 60 percent of adjusted gross income (less any excess investment interest included as an itemized deduction)
- o Intangible drilling costs ("IDCs") deduction in excess of the amounts deductible had the IDCs been capitalized and in excess of related income from oil and gas wells

-- Delete little-used preferences

- o Rapid amortization of pollution control facilities
- o Rapid amortization of child care and on-the-job training facilities.

Recommended Position

Since 1973, the Administration has consistently supported LAL and MTI as a dual mechanism to deal with tax shelters and taxpayers who through a pyramiding of exclusions and deductions do not pay their fair share of taxes. The Administration has also consistently opposed the present law minimum tax because its principal impact is on capital gains and, as an additional tax, it merely imposes a "slap on the wrist" toll charge for the use of preferences such as accelerated depreciation and percentage depletion.

With respect to LAL, Senator Kennedy and others are likely to bring up as a floor amendment an LAL proposal. It is also quite likely that this LAL proposal will apply to oil and gas activities. Given our public position as to LAL and oil and gas, we recommend support of LAL with an effective date as to oil and gas coincident with the effective date of price deregulation. This position would be consistent with the rationale advanced by Secretary Simon in his March 17, 1976 testimony before the Finance Committee.

With respect to the minimum tax, there is an outside chance that the Finance Committee at its meeting on June 10 may reverse its present position and opt for an alternative tax (similar to our MTI proposal) which would include in an expanded taxable income base both "exclusion" items of tax preference (e.g., capital gains) and "deferral type" items of tax preference (e.g., accelerated depreciation, construction period interest, etc.). We recommend support of such an alternative tax because:

-- The concept of an alternative tax is in accord with the general concept of our MTI proposal

-- An alternative tax would be more progressive than either the House Bill minimum tax or the present Finance Committee version of the minimum tax

-- An alternative tax would be a first step toward the long range goal of a broad based income tax with a lower rate structure.

If an alternative tax proposal does not emerge from the Finance Committee, it is not likely to be raised as an amendment on the Senate floor or, if raised, likely to succeed. The principal floor debate argument will be over the amount of the exemption and the offset for taxes. While we are generally opposed to an add-on minimum tax, it is necessary, nevertheless, to support some form of minimum tax in order to maintain our tax reform posture. Accordingly, we recommend support of a minimum tax along the lines of the House Bill, i.e., with a $20,000 exemption for preference income (phased out as preference income exceeds $40,000) and an offset for one-half of regular taxes paid.

With respect to the items of tax preference, our recommended position is as follows:

-- Present law items retained	Support
-- New items	
o Construction period interest	Support
o Accelerated depreciation on personal property subject to an operating lease	Oppose
o Excess investment interest	Support
o Itemized deductions in excess of 60 percent of adjusted gross income	Support
o IDCs in excess of related income	No objection*

2. MAXIMUM TAX

Description

Under present law, a maximum marginal rate of tax of 50 percent is imposed on personal service income ("earned income"). Earned income is limited to wages, salaries, professional fees and other compensation for personal services

*The impact on oil and gas is expected to be minimal since (1) related oil and gas income is taken into account, and (2) IDC deduction for dry holes will not be taken into account. The provision was supported by Senators Long and Bentsen and all of the Republican members of the Finance Committee.

including a reasonable amount of self-employment income (not to exceed 30 percent of the profits of the business). The amount of earned income which would otherwise be subject to the maximum tax is reduced on a dollar-for-dollar basis as preference income exceeds $30,000 in a taxable year.

The Finance Committee agreed to apply the maximum tax to a limited amount of investment income. The maximum tax would apply to a taxpayer's investment income no greater in amount than the taxpayer's earned income, but in no event could the investment income eligible for such 50 percent limitation exceed $100,000. Investment income would not include capital gains.

The Finance Committee also repealed the $30,000 exemption for preference income which is used to offset earned income otherwise eligible for the maximum tax and revised the list of preferences to conform with, and include, all items of tax preference subject to the minimum tax as adopted by the Committee. Current drafts of the new provision indicate that the offset for preference income will apply first to earned income. Once applied, the amount of earned income then determined eligible for the maximum tax (but not more than $100,000), will fix the amount of investment income eligible for the maximum tax.

Recommended Position

As a matter of tax policy, it is questionable (1) whether the lowering of the top marginal rates of tax should be limited to investment income, and (2) if so limited, whether the amount of income eligible for the maximum tax should be dependent upon the amount of earned income. Moreover, our analyses indicate that in some situations there may be perverse effects on the marginal rates because of the stacking rules, the allocation of deduction rules and the offset of earned income otherwise eligible for the maximum tax by the amount of preference income.

On the other hand, to the extent that a maximum tax on investment income may be viewed as a lowering of the top marginal rates of tax and as an inducement to preclude taxpayers from devoting their energies to seeking uneconomic tax shelter investments, the provision is a welcome development. Accordingly, we recommend that the Administration simply not object to this provision.

TITLE II -- OTHER TAX SHELTER PROVISIONS

Description

Like the House Bill, the Finance Committee adopted a number of provisions designed to curb tax shelter operations. The principal thrust of these provisions is twofold:

-- Tighten the depreciation recapture rules to prevent the conversion of ordinary income into capital gains (as in the case of real estate and sports franchises)

-- Impose "at risk" limitations to prevent the leveraging of tax shelter benefits through the use of nonrecourse loans. These provisions will limit the amount of accelerated deductions which may be taken on leveraged investments in oil and gas drilling, farm operations, equipment leases, and motion pictures transactions.

Further, the provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be allocated among the various partners unless these allocations have substantial economic effect. Finally, limitations are imposed on prepaid expense deductions by farm syndicates and on prepaid interest deductions.

Recommended Position

The tax shelter provisions, with minor exceptions noted below, are generally acceptable and we should support them. The recommended positions on each of the tax shelter provisions are as follows:

-- Recapture of depreciation on real property	Support
-- Extension of five-year amortization for rehabilitation of low income housing	Support
-- Termination of excess deduction account under section 1251	Support

-- Treatment of prepaid interest	Support with modification*
-- Repeal of limitation on deduction of excess investment interest	Support
-- Capitalization requirement for production service companies (movies, books, etc.)	Support
-- Capitalization of prepaid expenses by farm syndicates	Support
-- Special recapture rule for player contracts (sports franchises)	Oppose**
-- Partnership provisions	Support
-- Scope of waiver of statute of limitations in case of activities not engaged in for profit	Support

Treasury has consistently opposed "at risk" limitations, that is, limiting accelerated deductions to the extent of cash invested and recourse financing, for the following reasons:

-- Economically, there is no reason to distinguish between recourse and nonrecourse financing.

-- "At risk" limitations may be circumvented by other financing devices which have approximately the same tax consequences

-- The imposition of "at risk" limitations in combination with LAL (as in the House Bill) is overkill.

Although we have not publicly so stated, an "at risk" limitation would be an effective deterrent to certain sham transactions in which the seller finances the purchaser via a nonrecourse loan in an inflated amount in excess of the fair market value of the property purchased.

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* Modification suggested is a de minimis rule for administrative convenience.

**We do not believe that special recapture rules are warranted for sports franchises.

The Finance Committee version of the "at risk" limitation is a watered-down version of the House Bill parallel provisions. Under the Committee's version, cross-collateralization would be permitted, i.e., a taxpayer would be considered at risk not only with respect to cash and recourse loans, but also with respect to the fair market value of other property pledged as collateral for a nonrecourse loan.

We recommend continuing to oppose the "at risk" limitations as applied to oil and gas activities and equipment leasing transactions for the reasons previously advanced. However, given the mild nature of the Finance Committee provision, we should not treat this question as a priority issue. We do recommend supporting the "at risk" limitations in the case of motion picture films, livestock and certain crops.* In each of these cases, an at risk limitation is an effective deterrent to sham transactions as to which the Internal Revenue Service has had a difficult enforcement problem.

TITLE III -- BUSINESS RELATED INDIVIDUAL INCOME TAX PROVISIONS

The provisions of this title establish tighter rules on the deductibility of certain business related expenses by individuals. Our recommendations are as follows:

-- Deductibility of expenses attributable to business use of homes	Support
-- Deductibility of expenses attributable to rental of vacation homes	Support with modification**
-- Deductibility of expenses for attending foreign conventions	Support

* The "at risk" limitations were supported by the Naitonal Livestock Association and most of the farm groups.

**The Finance Committee rule limiting the amount of deductions to the amount of gross income derived from business use if a vacation home is used for personal purposes for more than 10 percent of the actual business use should be eliminated. Rather, the test should be a flat two-week rule.

-- Repeal of qualified stock option treatment coupled with exception for new or small businesses	No objection, but suggest modification*
-- Legislator's travel expenses away from home	No objection

TITLE IV -- SIMPLIFICATION OF INDIVIDUAL INCOME TAX PROVISIONS

The simplification provisions of this title are clearly a step in the right direction. With one exception, we recommend support of all the provisions.

-- Optional tax tables for taxpayers with taxable income under $20,000	Support
-- Alimony deduction allowed in computing adjusted gross income	Support
-- Revision of retirement income credit	Support,** with no objection as to phase-in of maximum amount for credit computation
-- Changes in exclusions for sick pay	Support
-- Credit for child care expenses	Oppose***

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* The Finance Committee rule provides that the value of an option at the time of grant constitutes ordinary income. This is an unadministrable rule (i.e., valuing the option privilege of an option to purchase stock of a closely-held company is extremely difficult). A more appropriate rule would be to impose no tax on either the grant or exercise of an option, but tax, at ordinary income rates, gain on the disposition of the stock (the principal tax benefit of the option being the value of the tax deferral).

** Maximum amount on which credit is computed is phased-in over three-year period. House Bill provided for immediate maximum amount. We supported House Bill provision.

***Consistent with prior Administration position.

-- Moving expenses	Support
-- Accumulation trusts	Support
-- $50 floor on gasoline tax deduction	Support

TITLE V -- EXTENSION OF TAX CUTS

This item was discussed at a previous meeting of the Economic Policy Board and is not, therefore, discussed in this memorandum.

TITLE VI -- CAPITAL FORMATION

1. Two percent investment credit for ESOPs.

The Finance Committee bill would provide a permanent 10 percent investment credit, with an additional 2 percent investment credit (total of 12 percent) for corporations that elect to contribute an equivalent amount of corporate stock to an Employee Stock Ownership Plan (ESOP). The Tax Reduction Act of 1975 provides, for 1975 and 1976, an additional 1 percent investment credit for ESOPs.

Treasury has generally been opposed to the 1 percent investment credit for ESOPs but has not pressed its opposition in public discussion. Instead, we developed the Broadened Stock Ownership Plan (BSOP). In the Finance Committee we indicated we would not object to adding an ESOP element to the electric utilities package if the Committee also adopted BSOP. We expressed no position on an additional 1 percent or 2 percent investment credit for ESOPs applicable across the board to all corporations.

The additional 2 percent credit for ESOPs is undesirable because:

-- Participation in benefits is limited to corporate employees. Government employees, employees of exempt organizations, employees of noncorporate enterprise, and employees of closely-held corporations unwilling to share ownership with employees are excluded.

-- One hundred percent of funding is federal money. It is a populist income transfer program plain and simple.

-- Even among corporate employees, benefits are distributed arbitrarily, with employees of capital intensive industries and leasing companies receiving greatest benefits.

ESOPs themselves have a number of undesirable features--including greater potential risk due to lack of investment diversification or leveraging of investment, stock valuation problems, and fiduciary responsibility issues (the latter rules made inapplicable to ESOPs by the Committee's latest action).

We recommend, therefore, opposing the 2 percent investment credit for ESOP.

2. Refundable investment credits.

The Finance Committee bill makes investment tax credits for new investments refundable at the end of the credit carryover period if they have not been previously utilized. This accords with the consensus reached at the April 9 meeting between Senator Long, Secretary Simon, Mr. Seidman Assistant Secretary Eberle, and Assistant Secretary Walker Accordingly, we stated during the Finance Committee markup that we had no objection to such a provision. The first refunds under the provision would be made in 1984.

There are a number of reasons to support refundability of the investment credit:

-- Investors could determine the cost of an investment with greater assurance.

-- Complicated lease transactions to shift investment credits to firms that can use them would no longer be necessary.

-- Elimination of carryover rules would simplify the law.

However, there are also a number of reasons to oppose making the investment credit immediately refundable.

-- Immediate refundability would be very expensive--about $2.2 billion in the first year. There may be a number of better ways to spend that amount of money.

-- A refundable investment credit would present most starkly the question whether tax exempt entities should qualify. Our economists believe they should not.

We recommend that we communicate to appropriate Congressional and business leaders (such as the representatives of leasing firms) our concern that the question of immediate refundability may come up during the floor debate and discuss with them some of the pros and cons of this issue. Our formal position should be opposition to immediate refundability, or its equivalent, because of the revenue cost.

3. Extended carryover period for investment tax credits and foreign tax credits expiring in 1976

The Finance Committee Bill would extend through 1978, the carryover period for investment tax credits and foreign tax credits that would otherwise expire in 1976.

On October 20, 1975, we reported unfavorably on H.R. 8670, which would make expiring credits refundable. Our objections were basically that (1) making expiring credits refundable would provide a retroactive windfall for holders of unused credits dating back to 1965, (2) the benefits would be allocated disproportionately to the transportation sector, and (3) it would be preferable, if special aid for the airlines is deemed desirable, to provide on budget appropriations targeting recipients more thoughtfully than would be possible through a tax provision allocating benefits on the basis of the accidental distribution of expiring investment credits.

The proposed extension of the investment credit carryover period is just a partial step toward refundability for expiring credits and would keep the 1976 credits alive so that an attempt can be made at a later date to make them refundable.

We recommend continuing to oppose this provision for the reasons stated in the report on H.R. 8670. It would also be appropriate to oppose the extension of the foreign tax credit carryover period.

4. Increase in tax limitation for investment tax credits of railroads

The Finance Committee Bill would permit railroads to offset investment tax credits against 100 percent of tax liability for two years, decreasing to 50 percent over five years.

In its January 1975 tax cut proposals, the Administration recommended that the tax limitation be increased to 75 percent for public utilities, reducing to 50 percent over a five-year period; and the Tax Reduction Act of 1975 adopted for utilities a temporary increase to 100 percent along the lines here proposed for railroads.

Our investment tax credit recommendations for utilities in 1975 were founded on the premise that the basic problem for utilities has been the reluctance of state regulatory commissions to grant adequate rate increases. In contrast, the difficulties of the railroads are attributable to a number of factors, including competition from trucks and the imposition on railroads of substantial real property taxes for their road beds, which the truckers do not have to pay since they use public highways. In short, it is difficult to justify special tax breaks for railroads as a transition measure. Their problems are more fundamental.

We recommend that opposing special treatment for railroads that would simply establish an undesirable precedent for bailing out other industries that may get into economic difficulty. We are advised informally by the Transportation Department staff that they are pursuing the policy of trying to make transportation profitable in its own right and hope to eschew the use of tax gimmicks such as this. Accordingly, we would not expect DOT to object to our opposing this provision.

5. Allowance of investment tax credit for ships constructed with capital construction funds

The Finance Committee Bill would make ships constructed with funds withdrawn from Capital Construction Funds (established under the Merchant Marine Act of 1970) eligible for the investment tax credit. On December 15, 1975, Treasury, before the Ways and Means Committee, suggested that such a provision would run afoul of traditional notions of "basis" and the central concept of "depreciable property;"

that it would be preferable, if an additional subsidy is to be provided to shipping, to use either "on budget" annual appropriations or a clearer and more easily identifiable tax subsidy (such as a higher investment credit rate) rather than a complicated interaction of the investment credit and deductions for contributions to a capital construction fund; that the existing tax advantages for shipping were equivalent to tax exemption and to expensing costs of a qualified vessel; that the commercial ship construction industry appeared quite healthy; and that the proposed measure could eventually result in a revenue loss of approximately $75 million annually.

We recommend continuing to oppose this provision on the same grounds.

6. Option to elect eight-year net operating loss carryforward

The Finance Committee Bill would provide an option to elect an eight-year net operating loss carryforward period in place of the three-year carryback and five-year carryforward period provided by present law.

We recommend supporting the net operating loss election provided it is prospective only.

7. Extended capital loss carryover period for mutual funds

The Finance Committee Bill would extend the capital loss carryover period for mutual funds from five to eight years.

We recommend continuing to support this provision.

8. Five-year amortization and two-thirds investment credit for pollution control equipment.

The Finance Committee Bill would allow five-year amortization and two-thirds investment credit for pollution control equipment installed in existing facilities. The five-year amortization provision for pollution control equipment enacted by the Tax Reform Act of 1969, which expired at the end of 1975, does not allow the investment credit.

We have not made an issue out of prior extensions of the provision for five-year amortization without the investment credit, since it provided no net advantage to taxpayers and was not utilized. In commenting on proposals to allow current expensing of pollution control facilities, we have suggested that from an economic standpoint the cost of pollution control should be reflected in the cost of the products produced by industries whose production processes give rise to pollution control problems. While we recognize that changes in pollution control requirements may impose particular adjustment difficulties justifying transitional relief, it would appear that an adequate transition period has already been provided.

We recommend opposing this provision.

9. Exclusion from regulated public utility income of contributions in aid of construction

The Finance Committee Bill would overturn Revenue Ruling 75-557 and would restore the prior rule under which contributions in aid of construction to a regulated public utility are excludable from income and the utility may not depreciate the contributed facility.

Allowing an exclusion from income for contributions in aid of construction is tantamount to allowing regulated public utilities to expense capital investments. That is objectionable in the case of public utilities for the same reason that it is objectionable in the case of shipping companies who may deduct contributions to capital construction funds under the Merchant Marine Act of 1970. Nevertheless, we should recognize that public utilities will face difficulties during a transition period until utility commissions can act to adjust their practices to the new tax rules.

We recommend opposing the Finance Committee Bill provision, but would support a reasonable transition rule under which an increasing portion of contributions in aid of construction would be included in public utility income during a transition period of, say, five years. Under this approach, 20 percent might be included in the first year, 40 percent in the second year and so on.

10. Deductibility of prepublication expenses.

The Finance Committee Bill provides that until new regulations are issued, book publishers and authors may continue to deduct prepublication expenses, if that was the particular firm or individual's prior consistent practice. A similar provision in the House Bill was limited to publishers.

We opposed this provision in both the Ways and Means and Finance Committees, pointing out in the Finance Committee that the offending Revenue Ruling has been withdrawn pending the development of new proposed regulations. We also noted that if retroactive application of a capitalization requirement was found to be inequitable, Treasury would support the prospective application of any new proposed regulation. Nevertheless, the book publishers and authors mounted an effective lobbying effort, and we were unsuccessful in opposing this provision.

We recommend continuing to oppose this provision.

TITLE VII -- ENERGY RELATED PROVISIONS

With some modifications, the Finance Committee approved most of the provisions of last year's energy tax bill which the Treasury opposed when Secretary Simon testified before the Committee on March 17, 1976. The only provision we supported was a home insulation tax credit with a maximum of $150. The Finance Committee has extended it to 30 percent of the first $750 (or maximum of $225) and has also made the credit refundable.

The other principal energy tax provisions include:

-- Automotive energy conservation programs

  o Exempt of all buses and bus parts from manufacturer's excise tax

  o Exempt from Federal excise tax on oil (6¢ per gallon) new oil mixed with rerefined oil under certain circumstances

  o Exempt nonhighway use of special motor fuels from 4¢ per gallon excise tax on special motor fuels (exemption includes use of propane by industrial lift-trucks)

-- Nonbusiness energy conservation programs o Refundable tax credit for residential solar or geothermal energy equipment--40 percent of first $1,000, plus 25 percent of next $6,400 of expenditures (maximum credit of $2,000)

o Refundable tax credit for heat pumps in existing (but not new) residences--20 percent of first $1,000, plus 12-1/2 percent of next $6,400 of expenditures (maximum credit of $1,000)

-- Business energy conservation programs

o Nonrefundable 10 percent investment tax credit for insulation expenditures on existing (but not new) business or commercial structures

o Nonrefundable 20 percent investment tax credit for solar and geothermal energy equipment installed in new or existing business or commercial structures before January 1, 1981; 10 percent credit for period from January 1, 1981 to December 31, 1985. No credit after December 31, 1985.

o Variable investment tax credits for energy use property as follows (in each case, add 1 percent if taxpayer contributes amount equal to additional 1 percent to ESOP)

. 12 percent for a five-year period as to machinery or equipment necessary to permit waste to be used as a fuel

. 12 percent for 10-year period as to oil shale equipment and coal slurry pipelines. Also applicable to coal liquification and coal gasification equipment and equipment to remove pollutants from coal by in-factory processes

. 12 percent for a five-year period as to machinery, equipment and structural components of under-ground coal mines

. 12 percent for a five-year period as to equipment for conversion of organic material into methanol or other synthetic fuels which can be substituted for or blended with conventional fuels

. 12 percent for a five-year period as to equipment installed in business, residential or commercial structures which permits use of geothermal energy

o Denial of investment tax credit for portable-type heating and air-conditioning units

-- Geothermal energy development*

o Extend intangible drilling cost deduction to geothermal energy development activities

o Extend 22 percent depletion deduction to geothermal property income

-- Miscellaneous

o Eliminate U.S. tariff on imports of Canadian crude oil if acquisition is in exchange for equivalent amount of domestic crude oil of same kind and quality

o Foreign tax credit available for a five-year period under production sharing contracts (treat as taxes paid on oil extraction income an amount equal to 48 percent of foreign extraction income from that contract) credit to apply only to the extent there are no excess creditable foreign taxes from other extraction operations

*We support an elective five-year amortization of research and experimental expenses for a limited period (10 years).

o Present law rule that denies creditability for foreign taxes where taxpayer has no economic interest in the oil and gas is postponed for a 10-year period as to any oil and gas field in which taxpayer in the past has had an economic interest

In addition, the Finance Committee adopted a recycling tax credit for certain metals, textiles, waste paper, glass and plastics.

Treasury and FEA have consistently opposed all of the above provisions (except for the home insulation credit) on the grounds that a free market system will provide adequate incentives and that selective tax credits are undesirable and only lead others to seek equal treatment. For these reasons, we recommend continuing to oppose all of these provisions and pushing for a modification of the insulation credit along the lines proposed by the Administration.

The Finance Committee also adopted a number of technical amendments to the depletion rules (as amended by the Tax Reduction Act of 1975) to correct unintended results and clarify certain of the ambiguities. We recommend supporting these changes.

TITLE VIII -- FOREIGN TAX PROVISIONS

In general, the Finance Committee adopted provisions in the foreign tax area which are similar to those in the House Bill. We generally supported the foreign provisions of the House Bill and continue to support most of the foreign provisions of the Senate Bill. There are, however, five notable exceptions which are discussed below.

1. Boycott provision

The Finance Committee adopted a new rule which would penalize companies which participate in the Arab boycott of Israel by denying the foreign tax credit, ending deferral, ending DISC benefits, and denying the earned income exclusion for employees, with respect to operations in Arab countries.

We expressed strong opposition to this rule -- first, in a bill report and, then, orally at the mark-up session.

In response to a request by Senator Long to hear from Secretary Kissinger, Deputy Assistant Secretary Katz orally opposed the bill at the mark-up session. Although Long opposed the provision, it was adopted by the Committee.

In our judgment, there is substantial support for this provision on the floor of the Senate. Thus, any effort to strike the provision on the floor of the Senate would be likely to lose by an overwhelming vote. On the other hand, there is a substantial chance that it may be possible to delete the provision in conference. It would be much harder to delete the provision in conference if there had been a Senate floor vote in favor of the provision. It would be much easier to delete the provision in conference if Secretary Simon and Secretary Kissinger made personal pleas to the conferees concerning this issue.

We recommend, therefore, that we initiate no move on the floor of the Senate with respect to the boycott provision, but that Secretaries Simon and Kissinger make personal pleas to the conferees to delete this provision.

2. Bribe provision

The Finance Committee adopted a new rule which would penalize companies which bribe foreign officials by denying the foreign tax credit, ending deferral, and ending DISC benefits, with respect to bribe-related income.

We opposed this provision in a bill report and orally in the mark-up session on the grounds that (1) it was not a proper use of Internal Revenue Service personnel to investigate foreign bribes, (2) the bill was technically deficient in that it was very difficult administratively to determine the amount of bribe-related income, and (3) no changes should be made in this area until the Richardson Committee had studied the matter and prepared a report. Our opposition was not overly strong. We informally suggested to the staff that the bill would be preferable if the penalty applied to the amount of the bribe instead of to the amount of the income produced by the bribe. This approach would be easier to administer and would be parallel to the approach used with respect to domestic corporations where a deduction for the amount of the bribe is disallowed.

Again, as with the boycott provision, we believe there is substantial support for this provision on the floor of the Senate, and that no floor action should be initiated by the Administration.

We recommend, therefore, that we initiate no move on the floor of the Senate with respect to the bribe provision, but that it be recommended to the conferees to delete this provision, or alternatively, to amend the provision to tie the penalty to the amount of the bribe.

3. DISC

The House had excluded military sales and agriculture from DISC and had adopted an incremental approach so that DISC benefits were available for sales in excess of 75 percent of base period sales. The Finance Committee excluded only military sales which are not in competition with foreign products, and adopted an alternative 60 percent incremental approach with a different base period.

We have strongly opposed making any substantive changes to the DISC provisions.

The Finance Committee amendment to DISC has a solid majority of the Committee. We believe it can withstand attack on the floor because it raises substantial revenue from DISC and because the amendment was co-authored by Senator Mondale. In our judgment, many liberals and tax reformers will support the Finance Committee compromise. These Senators probably would vote against a floor amendment to repeal DISC, and an amendment to repeal it likely would fail.

Senator Long has indicated to us that he would support a floor amendment to retain DISC in its present form. However, we question whether there are sufficient votes to carry such an amendment, and tend to conclude that such an amendment is more likely to backfire and result in the complete repeal of DISC rather than succeed.

Assuming the Finance Committee version of DISC is passed by the Senate, we believe there is a reasonable chance in conference to adopt an approach to DISC which uses the House incremental formula and which extends the DISC benefits to agriculture and military sales.

We recommend that we initiate no move on the floor with respect to DISC, but that efforts be made in conference to adopt the House incremental formula, retaining DISC for agricultural and military sales.

4. Withholding tax

The Ways and Means Committee bill had repealed the withholding tax on nonresident aliens and foreign corporations for portfolio interest and dividends. This provision was struck on the floor of the House by an overwhelming vote. The Finance Committee Bill would repeal the withholding tax only on interest.

We have urged all along that the withholding tax be repealed for all interest and dividends. We think that it is unlikely that the Senate would vote in favor of repealing the withholding tax on dividends. Moreover, it would be unlikely that the House would accept such an amendment, in light of the resounding negative vote on the floor of the House. It seems fairly likely, however, that the House conferees might accept the repeal of the withholding tax on interest only. There was no separate vote on the floor of the House on the interest question, and the negative vote with respect to the dividend and interest package may be explained as opposition to the repeal of the withholding tax on dividends.

We recommend continuing to support repeal of the withholding tax on interest and dividends.

5. Earned income exclusion

The House had phased out the exclusion for earned income of U.S. citizens living or residing abroad. The Finance Committee retained the basic exclusion, but eliminated some related abuses.

Treasury had quietly supported the House repeal of the earned income exclusion, but Treasury did not urge the Senate to take similar action. In general, we think that this is a no-win issue politically.

We recommend continuing to maintain a low profile on this issue and to the extent possible, giving advice and taking positions on a technical level only.

6. Other items

The other foreign tax provisions of the Finance Committee Bill and the recommended positions on those provisions, may be summarized as follows:

-- Income earned abroad by U.S. citizens living or residing abroad	
o Denial of foreign tax credit on income eligible for the exclusion	Support
o Taxation of nonexcluded income as if excluded income were in the tax base	No objection
o Inclusion of income earned abroad which is received outside of the country in which earned	Oppose
o Permitting standard deduction returns a foreign tax credit for foreign taxes paid	Support
o Exclusion of limited housing allowance	No objection
-- Income tax treatment of nonresident alien individuals who are married to citizens or residents of the United States	Support
-- Foreign trusts having 1 or more U.S. beneficiaries to be taxed currently to grantor	Support
-- Interest charge on accumulation distributions from foreign trusts	Support
-- Excise tax on transfers of property to foreign persons to avoid Federal income tax (excise)	Support
-- Amendment of provision relating to investment in U.S. property by controlled foreign corporations	Support
-- Repeal of exclusion for earnings of less developed country corporations for purposes of sec. 1248	Support
-- Exclusion from subpart F of certain earnings of insurance companies	No objection

-- Shipping profits of foreign corporations	No objection
-- Limitation on definition of foreign base company sales income in the case of certain agricultural products	No objection
-- Requirement that foreign tax credit be determined on overall basis	No objection
-- Recapture of foreign losses	Support
-- Dividends from less developed country corporations to be grossed up for purposes of determining U.S. income and foreign tax credit against that income	Support
-- Treatment of capital gains for purposes of foreign tax credit	Support
-- Foreign oil and gas extraction income:	
o Carryback of extraction taxes 1975, 1976, and 1977	No objection
o Transitional rule for foreign oil-related losses	No objection
o Interest included in oil-related income	No objection
o Percentage limitation on oil extraction taxes in the case of individuals	No objection
o Oil-related income of a public utility	No objection
o Repeals rules denying creditability for foreign taxes where there isn't economic interest in oil	Oppose
o Production-sharing contracts	Oppose
-- Source of underwriting income determined by looking at the location of risk	No objection
-- 3d-tier foreign tax credit when sec. 951 applies	No objection

-- Changes in ruling requirements under sec. 367, certain changes in sec. 1248	Support
-- Contiguous country branches of domestic life insurance companies	No objection
-- Transitional rule for bond, etc., losses of foreign banks	No objection
-- Tax treatment of corporations conducting trade or business in Puerto Rico and possessions of the United States	No objection
-- Repeal of Western Hemisphere trade corporations provision	Support
-- Repeal of provisions relating to China Trade Act Corporations	Support

TITLE IX -- ADMINISTRATIVE PROVISIONS

The Finance Committee Bill contains numerous provisions dealing with the administration of the tax law. On most of these issues, while Treasury is the principal spokesman before the tax-writing committees, its positions are developed in close consultation with the Internal Revenue Service. The principal Finance Committee provisions and our recommended positions are outlined below:

-- Disclosure of private letter rulings	Support
-- Disclosure of tax returns	Support
-- Income tax return preparers	Support
-- Assessment for mathematical errors	Support
-- Withholding provisions	
o military	Support
o gambling	Support
o state income tax of federal employees	No objection
o National Guard and Reserves	No objection

o City income tax of federal employees	No objection
o Sternmen (lobster fishermen)	No objection
-- State-conducted lotteries	Support
-- Jeopardy assessment	Support
-- Levies	No objection
-- Administrative summons	Support
-- Joint Committee refund cases and post-audit review	No objection
-- Use of Social Security numbers	No objection

TITLE X -- TAX EXEMPT ORGANIZATIONS

The Finance Committee Bill contains several provisions dealing with tax exempt organizations. The principal changes of interest deal with private foundations and include:

-- Reduction of the mandatory payout percentage applicable to private foundations to 5 percent and elimination of the Treasury Department authority to change that rate from year to year

-- Reduction from 4 to 2 percent of the rate of tax on private foundation income

We recommend support of both of these changes.

Other amendments pertaining to tax exempt organizations and our recommended positions are as follows:

-- Declaratory judgment procedure	Support
-- Self-dealing transition rules	No objection
-- Liberal use of the set-aside rule for new foundations	No objection
-- Extension of period to amend charitable remainder trusts to conform to Tax Reform Act of 1969	No objection

-- Exemption of county fairs and trade shows from the unrelated business income tax on rental income	No objection
-- Rules applicable to lobbying by public charities	Support

TITLE XI -- PENSION AND INSURANCE TAXATION

The principal pension provisions of the Finance Committee Bill and recommended positions are as follows:

-- A member of the Armed Forces Reserves or National Guard would be permitted to make tax deductible IRA contributions to an individual retirement account (IRA) for a year in which his service in the Reserves or National Guard is less than 90 days (excluding active duty for training).	No objection
-- A contribution of up to $750 could be made out of earned income to an H.R. 10 plan (without regard to the 25 percent overall limitation) by an individual for a year in which his adjusted gross income does not exceed $15,000	No objection
-- Extend to December 31, 1978 the time set for the Congress to study the appropriate tax treatment of employees covered under "salary reduction pension plans," "cash or deferred profit-sharing plans" and "cafeteria plans" which provide various nonqualified fringe benefits. This provision amends section 2006 of the Employee Retirement Income Security Act of 1974	No objection
-- Tax-exempt organizations maintaining section 403(b) annuities for their employees would be permitted to invest the funds so set aside with closed-end investment funds.	No objection

-- It would be made clear that a segregated asset account held by a life insurance company under a qualified pension or profit-sharing plan need not provide benefits in the form of an annuity. — No objection

-- Extend the coverage of the IRA provisions to nonemployed wives who are otherwise precluded from establishing IRAs. Up to $2,000 or 15 percent of earned income (whichever is less) could be contributed to an IRA established by a taxpayer for himself and his nonemployed wife. Such IRA's would have to provide that all funds set aside would be for the benefit of both spouses, under a joint and survivor arrangement. Alternatively, separate IRAs would be established for each spouse subject to a maximum annual contribution of $1,000 per spouse (subject to the same 15 percent of earned income limit set forth above). — No objection

With respect to insurance, the Finance Committee Bill has the following provisions:

-- Allow life insurance companies (both stock and mutual), on an elective basis, to file consolidated income tax returns with their property-casualty insurance and other corporate affiliates, effective beginning January 1, 1978. Under certain circumstances, the amendment would limit the amount of loss offset privileges (in any one year) with respect to net nonlife losses. Any net nonlife loss not allowed as an offset in one year would be available as a carryback or carryforward. — No objection

-- Correct an inadvertent omission in the Tax Reduction Act of 1975 which reduced the normal tax paid by most corporations from 22 percent to 20 percent of the first $25,000 of taxable income, but it did not reduce the normal tax of mutual property--casualty companies. Under the amendment, the normal tax of these companies would be conformed to the normal tax paid by other corporations.	No objection
-- Provide an amendment of the rules under which a life insurance company computes deductions with respect to nonparticipating policies. Under present law, the deductions are allowed with respect to nonparticipating policies which are issued or renewed for periods of five or more years. Under the amendment, for purposes of the five-year rule, the period for which a policy is issued or renewed includes the period for which it is guaranteed renewable.	Position to be determined
-- No imposition of income tax on income of a life insurance company where the tax would be deferred but for an inadvertent distribution of the income to the shareholders of the company. Permit the continued deferral of tax only if the amount distributed to the shareholders is repaid to the company before the time for filing the company's tax return for the year of the distribution. A shareholder's tax basis for computing gain or loss with respect to his stock in the company would not be affected by the distribution or repayment to the extent a dividend deduction or exclusion is allowed with respect to the distribution.	No objection

TITLE XII -- DEADWOOD BILL

Treasury has long supported enactment of the Deadwood Bill and continues to support it.

TITLE XIII -- MISCELLANEOUS

St. Nicholas visited the Finance Committee early this year. On May 27 and June 4, some 30 to 40 miscellaneous amendments were considered and adopted by the Committee. They range from a change in the excise tax structure on large cigars from a bracket system to an ad valorem tax of 8.5 percent (no objection), to a limitation on interstate tax on electricity between Arizona and New Mexico (not within Treasury's jurisdiction).