CHAPTER 3

MAKE THE SYSTEM MORE NEUTRAL AND FAIR

Part A. Excluded Sources of Income--Fringe Benefits

An employee is generally required to include in gross income all compensation received during the year from his or her employer, regardless of whether the compensation is paid in cash or in property or other in-kind benefits. Current law, however, exempts from taxation certain employer-provided in-kind benefits, such as the cost of group-term life insurance (up to $50,000), educational assistance, accident and health insurance, group legal services, and dependent care assistance. These and certain other fringe benefits are expressly excluded from an employee's taxable income if provided under qualified employer-sponsored plans.

Compensation paid in the form of in-kind benefits is not different in principle from compensation paid directly in cash. The employee who receives fringe benefits is not in a different pre-tax economic position than the employee who receives cash compensation and uses it to purchase the same benefits. The exclusion of certain fringe benefits from income under current law is thus unrelated to the proper measurement of income. It is intended instead to reduce the after-tax cost of certain goods or services and thereby to subsidize consumption of such items by eligible taxpayers.

The exclusion of fringe benefits from income has economic and social costs that have not always been reflected in political debate over fringe benefit tax policy or in individuals' expressed judgments about the desirability of maintaining existing tax preferences for fringe benefits. The incentive for consumption of fringe benefits created by their exemption from tax may overstimulate demand, producing losses in efficiency and artificially high prices. Nontaxation of fringe benefits also raises significant fairness concerns, since nontaxable benefits are not available to all taxpayers and are of greater value to high-bracket taxpayers. Finally, and most importantly, the exclusion of fringe benefits from income loses significant tax revenue, thus causing tax rates to be higher than they would be if fringe benefits were taxable.

The costs entailed in excluding fringe benefits from the tax base may be justified to the extent employer provision of fringe benefits serves significant social policy objectives that might otherwise fall to government and government-funded programs. This rationale for the nontaxation of fringe benefits requires, however, that the availability of an income exclusion be conditioned on the provision of fringe benefits on a broad, nondiscriminatory basis. It suggests as well that fringe benefits be excluded from income only where they directly and significantly enhance employee health and security.

INCLUDE IN INCOME A LIMITED AMOUNT OF EMPLOYER-PROVIDED HEALTH INSURANCE

General Explanation

Chapter 3.01

Current Law

All employer contributions to health insurance plans on behalf of an employee are excluded from the employee's gross income, regardless of the cost or extent of the coverage. The same rule generally applies to amounts paid by an employer to or on behalf of an employee under a self-insured medical plan.

Although medical expense reimbursements under a self-insured plan must be provided on a nondiscriminatory basis to be excludable, similar benefits provided through an outside insurer are not subject to nondiscrimination rules.

Reasons for Change

The exclusion of employer-provided health insurance from income subsidizes the cost of such insurance for eligible taxpayers. Although this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services, in its present form, the exclusion contributes substantially to horizontal inequity and to higher than necessary marginal tax rates.

The exclusion from income of employer-provided health insurance is unfair to individuals who are not covered by employer plans and who must therefore pay for their health care with after-tax dollars. Table 1 illustrates the impact of the exclusion on two employees each of whose compensation costs his respective employer $35,000. Individual A receives $2,400 of his compensation in the form of employer-provided health insurance; Individual B receives all of his compensation in cash. As shown in the table, A's after-tax income is $809 higher than B's simply because some of his compensation is in the form of health insurance. B must pay for any medical expenses or privately purchased insurance out of his lower after-tax earnings.

The exclusion for employer-provided health care has also contributed to the erosion of the tax base and to consequent high marginal tax rates, especially as employer-provided health care has become increasingly widespread. Imposing a limited tax on employer-provided health care would help broaden the base of taxable income and thus reduce marginal tax rates without jeopardizing the national policy of encouraging essential health care services.

Table 3.01-1

Tax Benefits Arising from the Exclusion of Employer-Provided Health Insurance 1/

	Individual A	Individual B
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	2,400	---
Employer Social Security Tax	2,147	2,305
Cash Wages	30,453	32,695
Employee Income Tax	2,996	3,489
Employee Social Security Tax	2,147	2,305
After-Tax Income Plus Value of Health Insurance	**27,710**	**26,901**
Cost of $2,400 of Health Insurance	1,591	2,400

Office of the Secretary of the Treasury May 28, 1985

1/ 1985 tax rates for a family of four with no other income and with itemized deductions equal to 23 percent of adjusted gross income.

In addition, the tax benefits provided for employee health care should not be available on a basis that permits discrimination in favor of owners and high-paid employees. Thus, nondiscrimination rules should apply to employer-provided health benefits regardless of whether such benefits are self-insured or provided through third-party coverage.

Proposal

Employer contributions to a health plan would be included in the employee's gross income up to $10 per month ($120 per year) for individual coverage of an employee, or $25 per month ($300 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee).

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

In most cases, determination of the precise cost of coverage would be unnecessary, because the floor amounts would clearly be exceeded. In those cases where the floor amounts would not necessarily be exceeded, the following method of determining cost would be used.

The annual cost of providing coverage under an insured plan (or any insured part of a plan) would be based on the net premium charged by the insurer for such coverage. The annual cost of providing coverage under a noninsured plan (or any noninsured part of a plan) would be based on the costs incurred with respect to the plan, including administrative costs. In lieu of using actual administrative costs, an employer could treat seven percent of the plan's incurred liability for benefit payments as the administrative costs of the plan. A plan would be a noninsured plan to the extent the risk under the plan is not shifted from the employer to an unrelated third party.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs in a significant manner from the coverage of another group of employees.

The proposal would require that the cost of coverage under the plan be determined in advance of the payroll period. The cost would be redetermined at least once every 12 months, and whenever there are significant changes in the plan's coverage or in the composition of the group of covered employees.

If the actual cost of coverage cannot be determined in advance, reasonable estimates of the cost of coverage would be used. If an estimated cost were determined not to be reasonable, the employer would be liable for the income taxes (at the maximum rate applicable to individuals) and the employment taxes (both the employer's and the employee's share) that would have been paid if the actual cost of coverage had been used. Where an employer makes contributions to a multiemployer plan, the multiemployer plan would be treated as the employer for purposes of determining the cost of coverage and the liability for errors in estimates.

If the cost of coverage fluctuates each year depending on the experience of the employer under the plan, an average annual cost of coverage could be used, based, in appropriate circumstances, on the average cost for the past three years (adjusted to reflect increases in health insurance costs).

Appropriate nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties. See Ch. 3.04 for a description of the proposed nondiscrimination rule.

Effective Date

The proposal would apply to employer contributions received in taxable years beginning on or after January 1, 1986.

Analysis

The proposal would reduce the unfair distinction between those with employer-provided health insurance and those who must pay for health insurance with after-tax dollars. In the case illustrated in Table 1, under current law the employee with $2,400 of employer-provided health insurance paid $809 less in taxes than a similar family that purchased $2,400 of health insurance with after-tax dollars. Under the Administration proposal, the difference would fall from $809 to $611. The cost of $2,400 of employer-provided health insurance would rise from $1,591 to $1,789, due partly to the inclusion of $300 of employer contributions in income and partly to the reduction in the marginal tax rate for this family (from 22% to 15%).

The higher amount included in income for family coverage reflects the fact that such coverage is approximately two-and-one-half times as costly as individual coverage.

The proposal would be administratively simple, since almost all those with employer contributions will have such contributions in excess of the proposed includable amounts. Only in those rare cases where the employer's contribution is less than $10 (individual) or $25 (family coverage) per month would estimates of the average cost of health plan coverage be necessary. Moreover, the proposal's implementation need not be delayed, since it should have no major impact on the nature of negotiated contracts.

The distributional impact of this proposal is summarized in Table 2. Less than 20 percent of all employer contributions would be included in income, resulting in additions to taxable income for approximately half of all families. Families with incomes above $30,000 would pay three-quarters of the taxes imposed on employer contributions. Less than 5 percent of the additional tax liability would fall on those with under $15,000 of income. The additional tax liability is concentrated among higher income taxpayers for two reasons. First, as illustrated in the first two columns of Table 2, employer contributions for health insurance are much more common (and larger) for higher income families. Less than 15 percent of families with incomes below $15,000 receive such contributions, compared to over 80 percent of families with incomes over $50,000. Second, the tax rate on the included portion of employer contributions is higher for those with higher incomes. Given the proposed increases in the personal exemption and zero bracket amounts, no families with incomes below the poverty line would pay tax on employer contributions.

Table 3.01-2

Distribution of Employer Contributions for Health Insurance (1983), and Estimated Impact of the Proposal

Family Economic Income	Percent of Families Receiving Employer Contribution	Average Employer Contribution	Percent of Contributions Included in Income Under the Proposal	Distribution of Additional Tax Liability
$ 0 to 9,999	14 %	$ 60	19 %	* %
10,000 to 14,999	34	80	19	4
15,000 to 19,999	46	90	18	6
20,000 to 29,999	60	100	18	16
30,000 to 49,999	76	130	18	34
50,000 to 99,999	86	170	16	34
100,000 to 199,999	81	190	15	6
200,000 or more	76	200	14	*
All Families	56 %	$125	17 %	100 %

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* Less than 0.5 percent.

REPEAL $5,000 EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

General Explanation

Chapter 3.02

Current Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee are excluded from the recipient's income. The maximum amount that may be excluded from income with respect to any employee is $5,000. Accordingly, an allocation of this exclusion is required if multiple beneficiaries receive, in the aggregate, more than $5,000. Except with respect to certain distributions from or under qualified plans, the exclusion does not apply to self-employed individuals.

In addition to the statutory exclusion, some courts have permitted taxpayers to exclude from income payments from a decedent's employer in excess of $5,000. The rationale of these cases is that the employer's payment to the decedent's estate or beneficiary constitutes a gift rather than compensation. Such "gifts" are excludable without regard to the $5,000 limitation.

Reasons for Change

The exclusion of certain death benefits from income creates an artificial preference for what is, in effect, an alternative form of employee compensation. The exclusion of such benefits from the tax base causes the tax rates on other compensation to increase. Moreover, the exclusion is unfair because it is not available to all taxpayers (such as self-employed individuals).

Death benefits are similar to group-term life insurance, the exclusion for which is retained. The exclusion for group-term life insurance premiums, however, is conditioned on satisfaction of certain requirements, including a nondiscrimination test. Because of the nature of death benefits, it would be very difficult administratively to place the same conditions on their availability (or on imputed premiums for death benefits, which are also excluded). In the absence of such restrictions, death benefits may become more of a vehicle to provide tax-free compensation for highly paid employees, than a means to enhance the security of employees generally.

Finally, confusion exists under present law as to whether a payment by an employer to a deceased employee's family constitutes a death benefit subject to the $5,000 limitation or a fully excludable gift. Treatment of such a payment as a gift often is contrary to economic reality and leads to different tax treatment on similar facts.

Proposal

The proposal would repeal the $5,000 exclusion for employer-provided death benefits. Any amount paid by or on behalf of an employer by reason of the death of an employee to the estate or a family member or other beneficiary of the decedent would be characterized as a taxable death benefit rather than as an excludable gift.

Effective Date

The repeal would be effective for benefits paid due to deaths occurring on or after January 1, 1986. The exclusion would continue, however, for amounts paid under a collective bargaining agreement entered into before January 1, 1986, until the earlier of January 1, 1989, or the date such agreement terminates.

Analysis

Approximately $400 million of employer-provided death benefits are excluded from income under current law. As with all exclusions, the tax benefit per dollar of the death benefit exclusion increases with the recipient's tax bracket. Thus, the exclusion provides the greatest assistance to high-income taxpayers, who are also more likely to receive such benefits than low-income taxpayers.

Finally, a specific provision that payments from an employer to a deceased employee's estate or family do not constitute gifts would simplify current law and also reduce the unfairness created by current law where similar facts may lead to different tax results.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED COMMUTING SERVICES

General Explanation

Chapter 3.03

Current Law

The value of employer-provided commuting transportation is excluded from the income of employees if the transportation services are provided under a nondiscriminatory plan using vehicles that meet size and usage requirements (generally vans). The exclusion is not available to self-employed individuals and is scheduled to expire for taxable years beginning after December 31, 1985.

Reasons for Change

The exclusion of qualified transportation services from employee income is poorly designed to promote its intended purpose of energy conservation. The exclusion targets only one form of group transportation, employer-provided van pools. This may cause taxpayers to reject possibly more efficient but non-subsidized transportation alternatives. Moreover, the qualified transportation exclusion is not aimed at ensuring security for individual employees, but rather at achieving the general goal of energy conservation. This goal can be achieved more effectively and equitably through non-tax measures.

Proposal

The exclusion from gross income of the value of employer-provided commuting transportation would be allowed to expire.

Effective Date

Taxpayers have had notice of the scheduled expiration of the van-pooling exclusion for taxable years beginning after December 31, 1985. It would be allowed to expire as scheduled.

Analysis

Expiration of the van-pooling exclusion will eliminate an unnecessary distortion in employee and employer choices over cost-effective transportation.

ESTABLISH A UNIFORM NONDISCRIMINATION RULE

General Explanation

Chapter 3.04

Current Law

Overview. A variety of fringe benefits are excluded from the income of employees if provided by employers under certain statutorily prescribed conditions. Among those conditions is the general requirement that fringe benefits be provided on a nondiscriminatory basis. Thus, with the exception of the exclusion for employer-provided health insurance, each fringe benefit exclusion is subject to nondiscrimination rules that require that the benefit not be provided on a basis that favors certain categories of employees (the prohibited group members). Failure to satisfy the applicable nondiscrimination test results in a denial of the tax exclusion, and thus inclusion of the benefit in income, either for all employees receiving the benefit or only for prohibited group members.

Separate nondiscrimination rules apply with respect to each benefit. Thus, a prohibited group member for one benefit may or may not be a prohibited group member for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Group-Term Life Insurance Plans. If a group-term life insurance plan is determined to be discriminatory, the $50,000 exclusion of the cost of insurance does not apply with respect to key employees. A discriminatory plan is one which favors key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. For purposes of these rules, related employers are treated as a single employer.

With respect to eligibility, a group-term life insurance plan must satisfy one of the following tests: (1) the plan benefits at least 70 percent of all employees; (2) at least 85 percent of all participants are not key employees; (3) the class of employees receiving benefits is not discriminatory in favor of key employees; or (4) in the case of a plan which is part of a cafeteria plan, the cafeteria plan requirements are met. In determining whether a plan satisfies this eligibility test, employees who have not completed three years of service, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens who receive no U.S. earned income may be disregarded.

For purposes of determining whether the type or amount of benefits under the plan discriminates in favor of key employees, all benefits available to key employees must be available to all other employees, and benefits proportionate to compensation are considered nondiscriminatory.

The term "key employee" is generally defined as it is under the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners receiving at least $150,000 in annual compensation. Employees are key employees with respect to a year if they fall within one of the above categories at any time during the five preceding years.

Health Benefits Plans. The exclusion of health benefits provided by an employer through an insurance company, and the exclusion of medical benefits and reimbursements provided under such insurance, are not conditioned on the satisfaction of a nondiscrimination test. However, if an employer provides its employees with health benefits under a self-insured plan, the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent the reimbursement is not an "excess reimbursement," which generally is a reimbursement provided to a highly compensated individual under a discriminatory plan.

A self-insured health plan is discriminatory if it favors highly compensated individuals as to eligibility to participate or as to benefits. For purposes of this nondiscrimination rule, related employers are treated as a single employer.

Under the eligiblity test, a health plan must benefit (1) at least 70 percent of all employees, (2) at least 80 percent of all eligible employees, but only if at least 70 percent are eligible, or (3) a class of employees that does not discriminate in favor of highly compensated individuals. In determining whether a plan satisfies any of these tests, employees who have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

The benefits provided under a self-insured health plan will be treated as discriminatory unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

For purposes of these rules, highly compensated individuals are (1) the five highest paid officers, (2) shareholders owning more than ten percent of the stock of the employer, and (3) employees who are among the highest paid 25 percent of employees (excluding non-participants who may be disregarded for purposes of the eligibility test).

Group Legal Services Plans. The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a plan benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, the availability of the exclusion is subject to a concentration test under which no more than 25 percent of the amounts contributed during a year may be provided for five percent owners (or their spouses or dependents).

Educational Assistance Programs. The exclusion for amounts paid or expenses incurred by the employer for educational assistance to an employee under an educational assistance program is not available if the program benefits a class of employees that is discriminatory in favor or employees who are officers, owners, or highly compensated (or their dependents). Under this test, employees covered by a collective bargaining agreement may be disregarded. Also, the exclusion is subject to a concentration test under which no more than five percent of the amounts paid or incurred by the employer for educational assistance may be provided for five percent owners (or their spouses or dependents).

Dependent Care Assistance Programs. The exclusion for amounts paid or incurred by the employer for dependent care assistance under a dependent care assistance program is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a program benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance is provided for five percent owners (or their spouses or dependents).

Cafeteria Plans. The cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. For purposes of these rules, related employers are treated as a single employer.

A cafeteria plan does not discriminate as to eligibility to participate if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) there is a uniform year of service requirement of no more than three years.

A cafeteria plan will not be considered to discriminate as to contributions and benefits if statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants. If a cafeteria plan provides health benefits, the plan will not be treated as discriminatory if the following tests are met: (1) contributions on behalf of each participant include either 100 percent of the cost of health benefit coverage of the majority of highly compensated participants who are similarly situated or 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage under the plan; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation. If a cafeteria plan is maintained pursuant to a collective bargaining agreement, the plan is deemed to be nondiscriminatory.

A participant or individual is considered highly compensated for purposes of the cafeteria plan rules if he or she is an officer, a five percent shareholder, highly compensated, or a spouse or dependent of any of the above.

In addition, the availability of the cafeteria plan treatment for to key employees is subject to a concentration test, which provides that no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees. Related employers are treated as a single employer for purposes of this rule. The term "key employee" has the meaning given to such term for purposes of the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners with at least $150,000 in compensation.

Certain Fringe Benefits (Sec. 132). The exclusion of a no-additional-cost service or a qualified employee discount applies to a fringe benefit provided to an officer, owner, or highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a class of employees which does not discriminate in favor of such owners, officers or highly compensated employees. Meals provided at a company cafeteria that covers its direct operating costs are generally excluded from income, except that this general exclusion does not apply to employees who are officers, owners, or highly compensated if access to the cafeteria is provided on a basis which discriminates in favor of such employees. For purposes of these rules, related employers are treated as a single employer.

Qualified Tuition Reductions. The exclusion of a qualified tuition reduction applies to an officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated.

Welfare Benefit Funds. A voluntary employees' beneficiary association or a group legal services fund which is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules. Under these rules, no class of benefits may be provided to a class of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefit test merely because benefits are proportional to compensation. For purposes of these rules, related employers are treated as a single employer.

For purposes of the above rules, the following employees may be disregarded: (1) employees with less than three years of service; (2) employees who have not attained age 21; (3) seasonal or less than half-time employees; (4) employees covered by a collective bargaining agreement; and (5) nonresident aliens with no U.S. earned income. Under a special rule, if a benefit, such as group legal services, is covered by a separate nondiscrimination rule, that separate rule will apply in lieu of the rules described above.

The term "highly compensated individual" includes any individual who is one of the five highest paid officers, a ten percent shareholder, or among the highest paid ten percent of all employees. For purposes of determining the highest paid ten percent of all employees, employees that have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

These nondiscrimination rules also apply for certain other purposes. For example, they must be satisfied in order for an employer to be able to deduct contributions to a welfare benefit fund to provide post-retirement life insurance or health benefits. Also, post-retirement life insurance or a post-retirement health benefit provided through a welfare benefit fund will be subject to a 100 percent excise tax if the plan of which the fund is a part does not satisfy these nondiscrimination rules.

Reasons for Change

Nondiscrimination requirements are an integral part of the current provisions under which certain employer-provided fringe benefits are excluded from the income of employees. The tax-favored treatment of such fringe benefits significantly reduces the Federal income tax base and thus forces significantly higher marginal tax rates on wages, dividends, rents, and all other income not exempt from tax. These costs may be justified only if employer-provided fringe benefits fulfill important social policy objectives, and in this respect meet responsibilities that would otherwise fall to government and government-funded programs. Strict nondiscrimination rules are a necessary adjunct to this public policy rationale since they require that fringe benefits be nontaxable only where provided to a broad cross-section of employees. Nontaxable fringe benefits that favor key or highly compensated employees do not serve public policy objectives, but are instead a form of tax-preferred compensation for a limited class of employees.

The nondiscrimination rules that currently apply to fringe benefits are marred by inconsistency and by their failure to establish clear and administrable standards. The separate nondiscrimination rules applicable to each fringe benefit employ different definitions of the prohibited group members and establish different standards for nondiscriminatory coverage. These differences have no policy justification, and thus create unnecessary complexity for taxpayers and for the Internal Revenue Service. In addition, although employer-provided health insurance is among the most significant fringe benefits both in terms of its importance to employees and its revenue cost, it is not subject to nondiscrimination rules. As with other fringe benefits, the exclusion of such insurance from employees' income should be conditioned on its nondiscriminatory provision to a broad cross-section of employees.

The current nondiscrimination rules also provide inadequate guidance to taxpayers and to the Internal Revenue Service. Thus, the definition of prohibited group members is generally vague, leaving unclear, for example, who qualifies as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members.

The uncertainty with respect to the current nondiscrimination requirements has resulted in significantly different patterns of coverage for different employee groups. Cautious employers may adopt conservative plans, covering a broad cross-section of their employees. Other employers, however, may conclude that uncertainty in the law permits an agressive approach, and set up plans that focus benefits on management or highly compensated employees. The Internal Revenue Service's ability to monitor employer practice is limited under current law, since the facts and circumstances approach of the existing standards requires that compliance be tested through detailed examination of individual cases.

The uncertainty and gaps in coverage that are attributable to the current nondiscrimination rules outweigh the arguable benefits of those rules. A facts and circumstances approach does offer flexibility to employers, but similar benefits can be achieved without wholly abandoning workable, objective standards. Objective nondiscrimination tests, if combined with a procedure under which plans involving special circumstances could be reviewed by the Internal Revenue Service, would provide workable guidelines while retaining appropriate employer flexibility.

Proposals

Scope. The nondiscrimination rules described in the following paragraph would apply to employer-maintained group-term life insurance plans, health benefit plans (whether self-insured or through an insurance company), qualified group legal services plans (whether self-insured or through an insurance company), educational assistance programs, dependent care assistance programs, cafeteria plans, certain fringe benefits (sec. 132), qualified tuition reduction arrangements, and welfare benefit funds.

Prohibited Group Members. A uniform definition of prohibited group members would apply to the nondiscrimination test for each fringe benefit. Thus, in determining whether a fringe benefit is provided on a nondiscriminatory basis in a particular year, the prohibited group members would be defined to include any employee who, at any time during the three-year period ending on the last day of the plan year, met any one of the following descriptions: (1) an owner of one percent or more of the employer (under appropriate attribution rules); (2) an employee receiving at least $50,000 in annual compensation; (3) an employee who is among the top ten percent of employees by compensation or is among the highest three employees (this number would be adjusted for small employers) by compensation, but not if he or she receives less than $20,000 in annual compensation (former employees would be disregarded for this purpose); and (4) a family member of another prohibited group member for the year. The $50,000 and $20,000 figures would be indexed for inflation.

The appropriateness of the top ten percent and highest three employees portions of the prohibited group definition in identifying the prohibited group members will depend, in part, on an employer's salary structure. Thus, a mechanical rule would be provided to identify those situations where the ten percent and high three classes of employees are inappropriate and to expand or contract these classes accordingly. Also, adjustments to the three year lookback rule may be appropriate where the number of employees employed by the employer changes significantly during that three year period.

In the case of a benefit plan that covers former employees, an employee who was a prohibited group member for either the plan year in which he separated from service or the previous plan year would continue to be treated as a prohibited group member. Thus, if an employee falls within one of the descriptions set forth above at any time within the year of separation or any of the preceding three years, he or she would continue to be a prohibited group member in the year of separation from service and thereafter. Appropriate rules would be designed to address the situation where an employee returns to service after separation.

Nondiscriminatory Coverage. The exclusion from income of each employer-provided benefit would be subject to a nondiscriminatory coverage test requiring that the percentage of prohibited group members actually benefiting under a benefit plan not exceed 125 percent of the percentage of the other employees actually benefiting under the plan. In applying this test to contributory plans, only employees making the required contribution would be treated as actually benefiting under the plan.

In certain very limited situations, where compelling business reasons indicate that application of the 125 percent test would not be appropriate, such test would not be applied if a timely ruling is obtained from the Internal Revenue Service. For example, an employer may acquire another company during a plan year. The acquired company may not have provided its employees with a health plan or it may have provided a plan substantially different from that provided by the acquiring employer. It may thus be appropriate to treat both the acquiring employer's health plan and the acquired company's health plan, if they each satisfied the coverage test prior to the acquisition, as satisfying the coverage test for a limited period after the acquisition, in order to permit the post-acquisition employer to redesign the plans to satisfy the test. Of course, during the limited period, the acquiring company's plan would be required to satisfy any reasonable conditions that the Internal Revenue Service may impose as part of the timely ruling, such as that the plan satisfy the nondiscriminatory coverage test by reference to the entire post-acquisition company with a more liberal percentage (e.g., 150 percent) substituted for 125 percent. Relief from the 125 percent test may also be appropriate where a substantial number of an employer's employees do not elect health coverage under the employer's plan because they are receiving health benefits through, for example, their spouses' employers. The Internal Revenue Service would apply reasonable conditions on the continued validity of such rulings.

In addition, any classification of employees used by a plan for participation purposes would be required to be nondiscriminatory on its face. Thus, for example, if a plan provided that the bottom 20 percent of the non-prohibited group members by compensation were ineligible, the plan would not pass the coverage test even if the plan otherwise satisfied the 125 percent coverage test. A contributory plan or a plan that excludes a class of employees based on a bona fide job category would not be discriminatory on its face under this provision.

In addition, the coverage test is not satisfied if a requirement for benefiting under the plan is discriminatory. For example, even if the 125 percent test is satisfied, the nondiscrimination coverage test is not satisfied if any non-prohibited group participant was required, as a condition of plan participation, to have completed a longer period of service than the prohibited group participant with the shortest required service period. Another example would be where any non-prohibited group participant had to make a larger employee contribution than the prohibited group participant with the smallest required contribution.

Certain classes of employees would be disregarded in applying the 125 percent coverage test to an employer's benefit plan so long as the plan did not benefit any employee in such class. The classes of excludable employees would be as follows: (1) employees with less than one year of service (except in the case of an employer's health plan); (2) part-time and seasonal employees; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens who receive no U.S. earned income. Part-time employees would generally be defined as employees who in a week work less than the lesser of (i) 20 hours or (ii) one-half of the customary hours worked by full-time employees. Seasonal employees would generally be defined as employees who in a year work less than the lesser of (i) 1,000 hours or (ii) one-half of the customary hours worked by full-time employees. In the case of an employer-maintained health plan, in lieu of the one year of service rule, employees with less than 30 days of service would be disregarded. However, employees with less than 90 days of service would be disregarded in applying the 125 percent test to a health plan if the plan also provided the option of post-separation health coverage of at least 90 days under the same terms available to other plan participants.

Nondiscriminatory Availability. All types and levels of benefits available to any prohibited group participant in a plan must also be available to all non-prohibited group participants. Similarly, if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants. For example, if a non-prohibited group participant was required to spend $1,000 on dependent care before the participant was eligible to receive reimbursements for dependent care expenses and not every prohibited group participant was subject to the same condition, the plan would discriminate in availability.

Nondiscriminatory Benefits: Insurance-Type Benefits. Group-term life insurance, health benefits, and group legal benefits provided under employer-maintained plans would each be subject to a nondiscriminatory benefits test. Health benefits and group legal benefits would both be treated as insurance-type benefits, regardless of whether they are provided under an arrangement with an insurance company or on a self-insured basis. The definition of an employer-maintained plan would be modified to require a permanent, enforceable plan to qualify for a benefit exclusion.

For group-term life insurance, benefits would be treated as nondiscriminatory if the amount of insurance coverage provided to participants varies uniformly by compensation. Thus, no prohibited group participant would be permitted to receive coverage which is a higher multiple of compensation than the lowest such multiple for any non-prohibited group participant. Appropriate rules would establish how former employees would be treated under this test.

For employer-maintained health benefit plans, including self-insured reimbursement plans, benefits would be treated as nondiscriminatory if, in all respects, the health benefit coverage provided to any prohibited group participant is also provided to all non-prohibited group participants. For this purpose, two employees actually receiving different types of health benefit coverage would be considered to have received the same type of health benefit coverage if each had the choice of electing, without charge, either type of coverage or if each had the choice of electing either type of coverage for the same charge (or for a charge which is proportional to compensation or more than proportional to compensation). Also, if two employees receive the same type of individual health coverage and only one receives family health coverage in addition, the two employees will be deemed to receive the same health coverage if the family coverage was available to both employees without charge.

In the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits requirement. This rule would have special application to health plans offering both individual coverage and family coverage. These two types of coverage could be considered separate benefits and thus could be tested separately under the nondiscriminatory coverage and the nondiscriminatory benefits test. However, in determining whether a separate "family coverage health plan" is nondiscriminatory under the coverage test, only employees with spouses or dependents would be considered.

Appropriate integration rules would be applied where benefits provided under Medicare or other Federal, State, or foreign law, are properly taken into account under the employer's health benefit plan. In addition, health benefits provided under a plan to an employee may be coordinated with those provided under a plan maintained by the employer of an employee's spouse.

Disability coverage would be tested under the same nondiscriminatory benefit rules applicable to other health benefit coverage, except that the amount of the coverage would be permitted to vary with compensation in accordance with the rules applicable to group-term life insurance. Also, appropriate rules would be applied for disability plans that integrate with disability benefits provided under Social Security or other Federal, State, or foreign law. If a disability plan is integrated with disability benefits under Social Security or any other law, appropriate adjustments would also be required to the extent a qualified plan maintained by the same employer may be integrated with Social Security or such other law.

An employer's group legal plan would generally have to meet the nondiscriminatory benefits test applicable to health benefit plans. Thus, a group legal plan could not discriminate with respect to legal services coverage. However, family coverage and individual coverage may not be considered the same coverage as under the health plan rules. In addition, in determining whether a separate "family coverage plan" is nondiscriminatory under the coverage test, all nonexcludable employees would be considered, regardless of family status. As with health plans, the nondiscriminatory benefits test would be applied on a per capita basis. Also, if the legal services plan provides different types or levels of legal services coverage, each type or level of benefits must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits test.

As noted above, a plan would not qualify for an exclusion unless it is permanent. This means that an employer must establish the plan with the intention of maintaining it for an indefinite period of time. An early termination without a bona fide and unforeseeable business reason may indicate that the plan was not intended to be permanent, especially if the duration of certain life, health, or legal coverage coincides with the period during which one or more prohibited group participants have a need for such coverage.

Nondiscriminatory Benefits: Noninsurance-Type Benefits. An educational assistance program and a dependent care assistance program, as well as certain other fringe benefits (sec. 132) and qualified tuition reductions, would each be required to satisfy a nondiscriminatory benefits test under which the average amount provided for a prohibited group participant under the program may not exceed 125 percent of the average amount expended for a non-prohibited group participant.

In the case of educational assistance, only educational assistance expenditures for degree programs, whether they be post-graduate, college, high school, or a lower level, would be considered under the usage test. With respect to no-additional-cost services, qualified employee discounts, and qualified tuition reductions, a similar 125 percent test would be applied under which use of a service, discount, or reduction would be valued under appropriate rules.

Concentration Test. The current law concentration tests for group legal services, cafeteria plans, educational assistance, and dependent care would be retained with certain modifications. Instead of prohibiting concentration in favor of five percent owners or key employees, the rule would apply to the top twenty prohibited group members by compensation. (Appropriate rules would be provided for determining the top twenty prohibited group members by compensation.) Also, the contributions provided for prohibited group participants with respect to each of these benefits may not exceed 25 percent of the total contributions provided with respect to such benefit. In addition, the concentration test would apply to each fringe benefit excluded from income. Finally, as applied to educational assistance, the rule would be modified to apply only to education leading to a degree.

Former Employees. The nondiscriminatory coverage and benefit requirements and the concentration test would apply to former employees. However, former employees must be treated separately for purposes of these requirements. For example, if an employer provides health insurance to active and retired employees, the discrimination rules must be applied separately to the two groups.

Less Than Full-Time Employees. If an employee covered under a benefit plan works in a plan year less than the lesser of (i) 1,500 hours or (ii) 75 percent of the hours considered full-time, appropriate adjustments may be made in applying the nondiscriminatory availability and benefits tests. For example, if an employer maintains a contributory health plan, it may not be inappropriate to treat as nondiscriminatory under the availability and benefits tests a requirement that employees working less than 1,500 hours contribute a higher amount than the full-time employees.

Aggregation of Plans. For purposes of the nondiscriminatory availability and the nondiscriminatory benefits tests, employer plans covering a common prohibited group participant shall be treated as one plan unless each of the plans would satisfy the nondiscriminatory coverage test if 100 percent were substituted for 125 percent. Also, at the election of the employer, two or more plans of such employer may be treated as one plan.

Effect of a Finding of Discrimination. If a plan is discriminatory in coverage or benefits, or fails to satisfy the concentration test, the exclusion would not apply to prohibited group participants. In the case of group-term life insurance, health benefits, and group legal services, the exclusion of the value of the coverage under the plan would not apply. If the coverage under the plan were taxable to the prohibited group participants, however, any reimbursement of expenses under the plan would remain nontaxable. A finding of discrimination would not affect the exclusion of the coverage for non-prohibited group participants.

In the case where a prohibited group member participates in a discriminatory health benefit plan and a nondiscriminatory health benefit plan, the amounts taxable under the discriminatory plan would not reduce the amounts taxable under the nondiscriminatory plan. See Ch. 3.01 for a discussion of the amounts taxable under a nondiscriminatory plan.

Cafeteria Plans. The nondiscrimination tests applicable to a particular benefit, as described above, would continue to apply to such benefit even if it is offered under a cafeteria plan.

In addition, the cafeteria plan must satisfy the nondiscriminatory coverage test treating each employee eligible to make elections under the plan as benefiting under the plan. Also, the nondiscriminatory availability test would apply to a cafeteria plan. Thus, all types and levels of benefits available to any prohibited group participant must also be available to all non-prohibited group participants, and if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants.

In applying the nondiscriminatory coverage and benefits tests to each separate benefit offered under a cafeteria plan, a special rule would apply to reimbursements of medical, legal, or dependent care expenses under a reimbursement account. A reimbursement account for either medical, legal, or dependent care expenses would be deemed to satisfy the nondiscriminatory coverage and benefits tests if the average reimbursement for prohibited group participants in the cafeteria plan does not exceed 125 percent of the average reimbursement for non-prohibited group participants in the cafeteria plan. In applying this test, reimbursements for medical, legal, and dependent care expenses would be aggregated. A reimbursement account would generally be defined as an arrangement maintained by the employer which is funded in whole out of elective contributions by participants. Reimbursements of insurance premiums would not be permitted under reimbursement accounts. The current law rules otherwise applicable to reimbursement accounts (e.g., forfeitability) would continue to apply.

For purposes of testing each individual benefit under the nondiscriminatory coverage and benefits tests, each level or type of benefit elected under the cafeteria plan would be treated as a separate plan.

<u>Welfare Benefit Funds</u>. The nondiscrimination rules applicable to welfare benefit funds would be modified to conform to the proposed nondiscrimination rules. Thus, for example, a voluntary employees' beneficiary association would be precluded from discriminating in favor of those employees who are prohibited group members under the proposed definition. In addition, the 125 percent coverage test would apply.

<u>Aggregation of Employers</u>. The rules treating related employers as a single employer for purposes of the rules described in this proposal would be extended to each fringe benefit. Also, the leasing rules currently applicable to qualified plans would apply without regard to the safe harbor plan provisions of such rules.

Effective Date

The proposal would generally apply to fringe benefit plan years beginning on or after January 1, 1986. However, this general effective date would be January 1, 1987 with respect to employer-provided health care coverage. In addition, an exception would be made for fringe benefit plans maintained pursuant to a collective bargaining agreement entered into prior to January 1, 1986, until the first plan year beginning on or after the earlier of January 1, 1989 or the date such agreement terminates.

Analysis

The extension and strengthening of the nondiscrimination rules would help direct more of the benefits to those for whom the exclusions were designed. The coverage test, for instance, would assure that in most situations, non-prohibited group members would be covered in proportions close to that of the prohibited group members. For example, assume an employer has 20 prohibited group members and 80 non-prohibited group members and none of these employees may be excluded from the nondiscriminatory coverage test. Assume further that all of the prohibited group members are covered. In order to satisfy the 125 percent coverage test, at least 80 percent of the non-prohibited group members, i.e., 64 of the non-prohibited group members, must be covered.

REPEAL EXCLUSION FOR EMPLOYEE AWARDS

General Explanation

Chapter 3.05

Current Law

Gifts are excluded from the gross income of the donee. Whether an employer's award to an employee constitutes taxable compensation or a gift excludable from gross income depends upon the facts and circumstances surrounding the award.

If an employee award is excludable from income as a gift, the amount that can be deducted by the employer is limited by statute. In general, the cost of a gift of an item of tangible personal property awarded to an employee by reason of length of service, productivity or safety achievement may not be deducted by the employer to the extent that it exceeds $400. In the case of an award made under a permanent, written plan which does not discriminate in favor of officers, shareholders, or highly compensated employees, gifts of items with a cost up to $1,600 may be deducted, provided that the average cost of all items awarded under all such plans of the employer does not exceed $400.

The fact that an award does not exceed the dollar limitations on deductions has no bearing on whether the award constitutes taxable compensation to the employee; in all cases that issue depends on the facts and circumstances surrounding the award. Nevertheless, many taxpayers take the position that if the dollar limitations are not exceeded, the award automatically constitutes a gift and is excludable from the employee's income.

Reasons for Change

A gift for tax purposes is a transfer of property or money attributable to detached and disinterested generosity, motivated by affection, respect, admiration, or charity. The on-going business relationship between an employer and employee is generally inconsistent with the disinterest necessary to establish a gift for tax purposes. Moreover, in the unusual circumstances where an employee award truly has no business motivation, it should not be deductible as an ordinary and necessary expense of the employer's business.

Current law not only allows employee awards to be characterized as gifts but provides a tax incentive for such characterization. The amount of an employee award treated as a gift is excluded from the income of the employee, but the employer may nevertheless deduct the award to the extent it does not exceed certain dollar limits. Even to the extent an award exceeds those limits, gift characterization produces a net tax advantage if the employee's marginal tax rate exceeds that of the employer.

Current law also generates substantial administrative costs and complexity by requiring the characterization of employee awards to turn on the facts and circumstances of each particular case. The dedication of Internal Revenue Service and taxpayer resources to this issue is inappropriate, since relatively few employee awards represent true gifts and since the amounts involved are frequently not substantial.

Proposal

Gift treatment would generally be denied for all employee awards. Such awards would ordinarily be treated as taxable compensation, but in appropriate circumstances would also be subject to dividend or other non-gift characterization. De minimis awards of tangible personal property would be excludable by the employee under rules of current law concerning de minimis fringe benefits.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Available data concerning employee awards of tangible personal property is incomplete. Surveys indicate that businesses made gifts to employees totalling approximately $400 million in 1983. It is unclear what portion of these gifts were in the form of tangible personal property; however, the majority of these gifts were less than $25 in value. Less than ten percent of all employees are covered by an employer plan for such benefits. Thus, the proposal would affect few employees and would promote horizontal equity.

Part B. Excluded Sources of Income--Wage Replacement Payments

REPEAL EXCLUSION FOR UNEMPLOYMENT AND DISABILITY PAYMENTS

General Explanation

Chapter 3.06

Current Law

In general, any cash wage or salary compensation received by an employee is fully includable in the employee's income. Under current law, however, payments under a variety of programs designed to replace wages lost due to unemployment or disability are fully or partially exempt from tax.

Unemployment Compensation. If the sum of a taxpayer's adjusted gross income (determined without regard to certain social security and railroad retirement benefits and the deduction for two-earner married couples) and his unemployment compensation is less than a "base amount" ($12,000 for single returns and $18,000 for joint returns), unemployment compensation is totally excluded from gross income. If such sum exceeds the base amount, then the taxpayer's gross income includes the lesser of (i) one-half of such excess, or (ii) all of the taxpayer's unemployment compensation.

Thus, for example, if a married couple filing a joint return receives $8,000 in unemployment compensation and has no other income, the unemployment compensation will be totally excluded from gross income. On the other hand, if the couple has $18,000 of other income, one-half of the unemployment compensation will be included in their gross income. As income other than unemployment compensation increases, a greater percentage of unemployment compensation will be included (up to 100 percent if their other income equals or exceeds $26,000).

Disability Compensation. Workers' compensation payments as well as black lung benefits to disabled coal miners are fully excluded from income.

Reasons for Change

Net Replacement Rates. Most wage replacement programs pay benefits equal to a flat percentage of gross earnings, subject to minimum and maximum dollar limits. Although this percentage is generally stated as a gross replacement rate, the effect of a wage replacement program can be determined only by analyzing its "net replacement rates" -- the fraction of a worker's lost after-tax wages that the program replaces. Exclusion of wage replacement payments

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from income causes a program's net replacement rate to exceed its gross replacement rate. Assume, for example, that Individual A would have earned $25,000 last year and would have paid taxes of $5,000, leaving after-tax income of $20,000. If A is disabled and receives one-half of his gross earnings ($12,500) in tax-free wage replacement payments, the 50 percent gross replacement rate results in a 62.5 percent net replacement rate, since $12,500 is 62.5 percent of $20,000.

Fairness. The fairness of a wage replacement system must be examined in terms of net rather than gross wage replacement rates, since it is the net replacement rate that indicates what percentage of the individual's true loss in wage income has been restored. The current exclusion of wage replacement benefits from income typically causes net replacement rates to exceed gross replacement rates. Moreover, this excess increases with the tax rate of the recipient's family.

Assume, for example, that individuals A and B have identical jobs and that each earns $160 per week. Due to disability or unemployment, both suffer a loss of all wages, and each receives tax-free payments of $80 per week. Although each has a gross replacement rate of 50 percent, their net replacement rates may differ greatly. If A has several dependents and no other source of income, he would have paid no income tax on his $160 per week; thus his net replacement rate equals his gross replacement rate of 50 percent. On the other hand, if B's spouse has substantial earnings so that the family is in the 30 percent tax bracket, B's net replacement rate will exceed 70 percent because his $80 tax-free payment has replaced after-tax income of $112.

As illustrated by a comparison of net replacement rates, the exclusion of wage replacement payments from income under current law provides the greatest benefit to single taxpayers with no dependents and to taxpayers with other sources of income. Correspondingly, current law provides the least benefit to taxpayers with several dependents and no other source of income. Moreover, the exclusion generally results in higher net replacement rates for those unemployed or disabled for short periods than for those suffering from long-term unemployment or disability.

The current disparity in net replacement rates could be redressed by redesigning wage replacement programs to take total family income into account. This solution, however, would add greatly to administrative complexity. A more efficient approach would be to tax wage replacement payments, recognizing that payment schedules could also be adjusted to maintain average net replacement rates. This would ensure comparable net replacement rates for individuals receiving benefits under the same programs.

Work Incentives. Any wage replacement program will reduce work incentives by reducing the net gain from returning to work. This effect is greatest when such payments are nontaxable, since net wage replacement rates then increase with family income. For example, if a 66 percent net replacement rate is desired for families with income below the tax-free threshold, it will be necessary to provide a 66 percent gross replacement rate for low-wage workers. Unless benefit payments are based on need, however, a 66 percent gross replacement rate will result in net replacement rates in excess of 100 percent for low-wage workers from high-income families. Such high replacement rates are clearly undesirable. However, as long as payments are nontaxable and are not based on need, adequate net replacement rates for low-income families will create extremely high net replacement rates for low-wage workers from wealthier families.

With respect to unemployment compensation, taxing an increasing percentage of unemployment compensation as the recipient's income increases above his "base amount" creates peculiar work disincentives. For example, if a married individual receives $5,000 in unemployment compensation, each additional dollar that the individual or his or her spouse earns between $13,000 and $23,000 will require inclusion in their gross income of another $0.50 of the unemployment compensation. In effect, each additional dollar of earned income within that range increases their taxable income by $1.50, and thereby multiplies their marginal tax rate by 1.5 for each dollar of earned income within that range. Such perverse results are inevitable if such a phased-out threshold is used.

The conflict between minimum replacement rates and work incentives is greatly reduced if benefits are taxed, even if the average net replacement rate is maintained through higher payments.

Neutrality. Wage replacement payments are presumably reduced in recognition that they are nontaxable, thereby reducing the cost of funding such programs. If the programs are paid for by employers (either through insurance or taxes), exclusion provides an indirect subsidy to industries with high injury or layoff rates, and indirectly raises tax rates on other income. Since the cost of job-related injuries and anticipated layoffs is a real cost of production, this subsidy distorts market prices and resource allocation. Although neutrality could also be achieved by treating wage replacement programs as insurance and taxing employees on the "premiums" paid by employers, this would be administratively difficult and would do nothing to reduce the problems of fairness or work disincentives discussed above.

The exclusion from taxation may also hide the true cost of government-mandated programs from the policymakers who determine their scope and size. Taxing wage replacement payments would enable policymakers to make more informed decisions.

Proposal

All unemployment compensation would be included in income.

In addition, all cash payments for disability from workers' compensation and black lung would be included in income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, and payments for burial expenses. Includable payments would all be eligible for an expanded credit for the elderly, blind, and disabled. See Ch. 2.02. In order to protect low- and moderate-income disabled taxpayers, the proposal would make taxable disability payments eligible for a 15 percent tax credit. The amount eligible for the credit would be reduced by any Title II social security benefits and tier 1 railroad retirement benefits and by one-half of the excess of adjusted gross income over $11,000 ($14,000 for joint returns).

Effective Dates

The proposal would apply to all unemployment compensation received in taxable years beginning on or after January 1, 1987.

With respect to workers' compensation payments, the proposal would apply to all payments received by employees or their survivors for disabilities occurring on or after January 1, 1987. Payments received for a disability occurring before such date would remain nontaxable.

The proposal would apply to all black lung disability payments received in taxable years beginning on or after January 1, 1987, regardless of the date on which the disability occurred.

Analysis

In General. Taxing wage replacement payments would eliminate the disparities in net replacement rates under current law. It would thus be possible to replace a given percentage of lost wages for workers in low-income families without providing net replacement rates far above that rate for workers from families with substantial income from other sources. This would enable wage replacement programs to target the benefits to those who need them most.

Unemployment Compensation. Most unemployment compensation is now excluded from gross income. In 1982, only one-third of such payments were taxed. Of $20.6 billion in payments, only $7 billion were included in gross income. Over $3.8 billion was received by taxpayers with adjusted gross incomes between $18,000 and $30,000, more than 30 percent of which was excluded from gross income.

Most unemployment compensation is received by families with other sources of income. Unemployment compensation provided less than half of family income for more than 67 percent of those receiving benefits in 1983. Most unemployed individuals remain unemployed for less than

15 weeks, so their unemployment compensation supplements income from employment during the rest of the year. Under such circumstances, the exclusion of unemployment compensation from income provides an unnecessary and unfair tax advantage. For example, someone earning $15,000 during the year and receiving $3,000 in unemployment compensation now pays substantially less tax than another person who works all year and earns $18,000.

Any unemployment compensation program will necessarily create some work disincentives. The proposal, however, would eliminate the peculiar disincentives created by the threshold for taxing such benefits under the current system.

States may wish to adjust their unemployment compensation programs if all such compensation is included in gross income. A State that pays benefits equal to 50 percent of gross wages will provide net replacement rates of less than 50 percent to most unemployed workers. The Administration proposals include increased personal exemptions and zero bracket amounts, along with lower tax rates. As a consequence, most workers who are unemployed for a long time and have little access to other sources of income would pay little or no tax on their benefits. The proposed effective date would provide time, however, for States to adjust benefits to protect even more workers.

Disability Payments. By combining most of the special treatment for the disabled in a single tax credit, the proposal would ensure that preferential treatment for the disabled is provided in a fair and consistent manner. Workers receiving workers' compensation and black lung disability payments would be treated similarly to persons who are disabled and receive disability pay from their employer.

Workers' compensation rarely provides the primary source of income for a family. Most of those receiving workers' compensation are off work for less than three weeks, and less than one percent are permanently and totally disabled. Families receiving more than half of their income from workers' compensation are rare (less than 7 percent of all cases), and the majority of recipient families obtain less than 10 percent of their income from workers' compensation. Very few families (approximately 4 percent) received more than $7,000 in benefits in 1983.

Table 1 compares the 1987 tax-free levels of income under current law and the Administration proposals for selected families receiving workers' compensation. Due to the preferential treatment for disability income, their tax-free levels of income would continue to exceed those for non-disabled taxpayers, which are shown in the first row of the table. As a result of the increased personal exemptions and zero bracket amounts, combined with the expanded tax credit for disability income, the tax-exempt level of income would increase for the vast majority of those disabled for less than the full year. Moreover, workers disabled all year with no other source of income would pay no tax unless their benefits exceeded $21,176 (single),

Table 3.06-1

1987 Tax-Free Levels of Income for Those with Workers' Compensation and Black Lung Disability Payments

	Single		Joint (Couple)		Joint (Family of 4) 1/	
	Current Law	Proposal	Current Law	Proposal	Current Law	Proposal
Nondisabled Taxpayer	$ 3,700	$ 5,100	$ 6,060	$ 8,320	$ 9,721	$13,316
Workers' Compensation 2/						
Totally disabled one month						
$30,000 worker	5,367	6,767	7,727	9,987	11,388	14,316
$10,000 worker	4,256	5,656	6,616	8,876	10,277	13,649
Totally disabled six months						
$30,000 worker	13,700	13,883	16,060	17,070	19,721	19,843
$10,000 worker	7,033	8,433	9,393	11,653	13,054	15,399
Totally disabled all year						
Worker with no other income	3/	21,176	3/	31,211	3/	38,947
Black Lung 4/	7,914	9,314	12,381	14,617	18,149	18,795

Office of the Secretary of the Treasury May 28, 1985

1/ Assumes full use of earned income tax credit. For current law, assumes one earner.

2/ Assumes benefits equal two-thirds of lost wages.

3/ Unlimited amounts are now exempt from tax, but maximum benefits in most states will be less than $17,000 in 1989 (estimated by adjusting 1984 levels by the expected increase in wages).

4/ Benefits estimated to be $4,214 (single), $6,321 (couple), and $8,428 (family of four) in 1987.

$31,211 (couple), or $38,947 (family of 4). The maximum benefit payable in 1987 (estimated by adjusting 1984 benefits for expected increases in wages) would be less than these amounts in all but 5, 2, and 1 State respectively.

The tax-exempt level of income would also increase for those receiving black lung disability payments (who are all permanently disabled), as shown in Table 1.

As illustrated in Table 2, workers' compensation benefits are received primarily by middle- and high-income taxpayers. This is largely attributable to the fact that most of those receiving workers' compensation are off work for less than three weeks (with less than one percent permanently and totally disabled), and that such benefits are related to wage levels. Moreover, since each dollar of excluded income is worth more to those in higher tax brackets, the tax benefits from current law are concentrated among higher income families.

Table 3.06-2

Distribution of Workers' Compensation Payments by Economic Income

Family Economic Income	Percentage of All Families (Total Population)	Percentage of Cash Payments from Workers' Compensation
$ 0 - 9,999	15.0 %	4.1 %
10,000 - 14,999	12.7	7.4
15,000 - 19,999	11.7	8.3
20,000 - 29,999	19.3	22.2
30,000 - 49,999	23.3	33.7
50,000 - 99,999	15.4	22.4
100,000 - 199,999	2.1	1.3
200,000 or more	0.5	0.4
Total	100.0 %	100.0 %

Office of the Secretary of The Treasury May 28, 1985

Despite the extensive protection the proposal provides for the low- and moderate-income disabled, the taxation of these forms of disability income generates substantial revenue which can be used to reduce tax rates on other income. Moreover, the higher personal exemption and zero bracket amount would ensure that no families below the poverty line are taxed on income from any source.

The repeal of the exclusion is delayed until 1987 to allow the State and the Federal governments to make any desired compensatory changes in their benefit schedules. Moreover, in the case of workers' compensation, the repeal would apply only to those receiving workers' compensation for disabilities occurring on or after January 1, 1987.

Since most workers' compensation payments are made by private insurance companies, payments for past injuries are funded from premiums paid in the past. As a result, there is no easy way to adjust such payments for the change in tax status. No such grandfathering is proposed for the Federal black lung program because those payments can be adjusted, if desired, for all beneficiaries.

Part C. Excluded Sources of Income--Other

LIMIT SCHOLARSHIP AND FELLOWSHIP EXCLUSION

General Explanation

Chapter 3.07

Current Law

Current law provides an exclusion from income for the amount of certain scholarships or fellowship grants. In the case of candidates for a degree at an educational organization with a regular faculty, curriculum and enrolled body of students, any scholarship or fellowship grant is excludable unless it represents compensation for services. If teaching, research, or other services are required of all such degree candidates, a scholarship or fellowship grant is not regarded as compensation for such services.

Nondegree candidates may exclude scholarships or fellowship grants only if the grantor is a charitable organization, a foreign government or an international organization, or an agency of the United States or a State. The amount that may be excluded is limited to $300 per month, with a lifetime maximum of 36 months. This limit does not apply, however, to amounts received to cover expenses for travel, research, clerical help, or equipment, which are incident to the scholarship or the fellowship grant ("incidental expenses").

Compensation for past, present, or future services is generally not treated as a scholarship or as a fellowship grant. However, in addition to the special rule for degree candidates, there is an exception for certain amounts received under a Federal program. These amounts are treated as scholarships even though the recipient must agree to perform future services as a Federal employee as a condition of obtaining the scholarship.

Reasons for Change

Scholarships and fellowship grants confer a benefit on the recipient that should be taxed as income. The full exclusion of these benefits from income under current law is unfair to the ordinary taxpayer who must pay for education with earnings that are subject to tax.

In theory, it might be appropriate to include the full amount of any scholarship in income. In practice, this would create real hardships for many scholarship recipients. Scholarship awards are often made on the basis of need, and if students were taxed on such amounts, they would often not have the resources to pay the tax. Moreover, unlike most cases in which in-kind benefits are subject to tax, a scholarship is typically not provided in lieu of a cash amount and is not otherwise convertible to cash. The definition of income for tax purposes is appropriately limited by considerations of ability to pay. Accordingly, income from a scholarship for tax purposes should, in general, be limited to amounts that represent out-of-pocket savings for regular living expenses.

An exception for incidental expenses of nondegree candidates is also appropriate. Such expenses would typically be deductible as ordinary and necessary business expenses, and thus in most cases an exclusion simply provides an equivalent tax result.

Proposal

Scholarships and fellowship grants generally would be includable in gross income. In the case of degree candidates, scholarships would be excludable to the extent that they were required to be, and in fact were, spent on tuition and equipment required for courses of instruction, but not for room and board or other personal living expenses. In the case of nondegree candidates, reimbursements for incidental expenses (as defined in current law) would be excludable.

The special rules concerning performance of future services as a Federal employee and compensation for services required of all degree candidates would be repealed. Thus, the amount of any scholarship or fellowship grant representing compensation for services would be included in income, regardless of the employer for whom the services were performed or whether other degree candidates were required to perform similar services.

Effective Date

The proposal generally would be effective with respect to scholarships and fellowships received in taxable years beginning on or after January 1, 1986. However, if a binding commitment to grant a scholarship in the case of a degree candidate was made before January 1, 1986, amounts received pursuant to such commitment would be excludable under the current-law rules through the end of 1990.

Analysis

Degree candidates receiving scholarships that were used for tuition and fees would not be liable for tax by reason of the award. Moreover, even students receiving scholarships for expenses other than tuition and fees would not pay tax as a result of the award unless the student's total income exceeded the sum of the zero bracket amount and the personal exemption ($4,900 if single, and $8,000 for a married couple filing jointly, at 1986 levels).

REPEAL EXCLUSION FOR PRIZES AND AWARDS

General Explanation

Chapter 3.08

Current Law

In general, the amount of a prize or award is includable in income on the same basis as other receipts of cash or valuable property. Current law provides an exception to this general rule, however, for prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for this exclusion, the recipient of the prize or award must be selected without any action on his or her part to enter the contest or proceeding, and must not be required to render substantial future services as a condition of receiving the prize or award.

Reasons for Change

Prizes or awards increase an individual's ability to pay tax the same as any other receipt that adds to an individual's economic wealth. In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of the tax the individual would otherwise owe.

Proposal

The amount of any prize or award received by a taxpayer would be fully includable in income, regardless of whether for religious, charitable, scientific, educational, artistic, literary, or civic achievement. The rule of current law excluding certain prizes and awards from income would continue to apply, however, to the extent that the individual recipient of a prize or award designates that such prize or award go to a tax-exempt charitable organization.

Effective Date

The proposal would be effective for prizes and awards received in taxable years beginning on or after January 1, 1986.

Analysis

Repeal of the exclusion for certain prizes and awards would affect the tax liability of only a few taxpayers, but it would increase the perceived and actual fairness of the tax system by subjecting these persons to tax on the same basis as others.

Part D. Preferred Uses of Income

The Administration proposals would curtail itemized deductions for certain personal expenditures, in order to broaden the tax base, simplify compliance and administration, and allow rates to be reduced. The deduction for State and local taxes would be repealed, and the charitable contribution deduction would be eliminated for nonitemizers. The itemized deductions for charitable contributions, medical expenses, casualty losses, and principal-residence mortgage interest would be left unchanged. Changes to the itemized deduction for interest expense are described in Chapter 13.01 (limit on interest deduction). The deduction for miscellaneous expenses would be replaced with an adjustment to income. (See Chapter 4.01).

REPEAL DEDUCTION OF STATE AND LOCAL TAXES

General Explanation

Chapter 3.09

Current Law

Individuals who itemize deductions are permitted to deduct certain State and local taxes without regard to whether they were incurred in carrying on a trade or business or an income-producing activity. The following such taxes are deductible:

- State and local real property taxes.
- State and local personal property taxes. (In some States, payments for registration and licensing of an automobile are wholly or partially deductible as a personal property tax.)
- State and local income taxes.
- State and local general sales taxes.

Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes. Taxes incurred in carrying on a trade or business or which are attributable to property held for the production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-producing activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

Reasons for Change

Fairness. The current deduction for State and local taxes disproportionately benefits high-income taxpayers residing in high-tax States. The two-thirds of taxpayers who do not itemize deductions are not entitled to deduct State and local taxes, and even itemizing taxpayers receive relatively little benefit from the deduction unless they reside in high-tax States. Although the deduction for State and local taxes thus benefits a small minority of U.S. taxpayers, the cost of the deduction is borne by all taxpayers in the form of significantly higher marginal tax rates.

The unfair distribution of benefits from the deduction for State and local taxes is illustrated by recent tax return data. For example, in 1982 itemizing taxpayers in New York received an average tax savings of $1292 from the deduction, whereas itemizers in Wyoming on average saved only $257. In effect, the deduction requires taxpayers in certain communities to subsidize taxpayers in other communities. Moreover, the deduction effectively skews the burden of State and local taxes within particular communities. Consider the variation in effective sales tax rates for three persons facing a 6 percent State sales tax: a nonitemizer, an itemizer in the 50 percent tax bracket, and an itemizer in the 20 percent bracket. The nonitemizer pays the full 6 percent sales tax rate, whereas the two itemizers pay effective rates of 3 and 4.8 percent, respectively. The deduction thus causes effective sales tax rates to vary with a taxpayer's marginal income tax rate and with whether a taxpayer itemizes, and produces the lowest effective rate for high-bracket/high income taxpayers.

Erosion of the Tax Base. The deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. Repeal of the deduction is projected to generate $33.8 billion in revenues for 1988. Recovery of those revenues will permit a substantial reduction in marginal tax rates. Indeed, unless those revenues are recovered, tax rates will almost certainly remain at the current unnecessarily high levels.

The Fallacy of the "Tax on a Tax" Argument. Some argue that the deductibility of State and local taxes is appropriate because individuals should not be "taxed on a tax." The argument is deficient for a number of reasons. First, it ignores the effect of State and local tax deductibility on the Federal income tax base. Deductibility not only reduces aggregate Federal income tax revenues, it shifts the burden of collecting those revenues from high-tax to low-tax States. High-tax States effectively shield a disproportionate share of their income from Federal taxation, leaving a relatively greater share of revenues to be collected from low-tax States. Absent the ability to impose Federal income tax on amounts paid in State and local taxes, the Federal government loses the ability to control its own tax base and to insist that the burden of Federal income taxes be distributed evenly among the States.

Second, the "tax on a tax" argument suggests that amounts paid in State or local taxes should be exempt from Federal taxation because they are involuntary and State or local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies. Moreover, State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services and municipal garbage removal. In this respect, the determination by State and local taxpayers of their levels of taxation and public service benefits is analogous to their individual decisions over how much to spend for the purchase of private goods.

It is, of course, true that not all benefits provided by State and local governments are directly analogous to privately purchased goods or services. Examples include police and fire protection, judicial and administrative services and public welfare. These services nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities.

Finally, the "tax on a tax" argument is contradicted by the practice of most States with respect to their own tax systems, including many of those with high tax rates. Federal income taxes are allowable as a deduction from State individual income taxes in only 16 States and from State corporate income taxes in only seven States. New York and California, States with very high tax rates, are among the States that deny a deduction for Federal income taxes.

Inefficient Subsidy. The deduction for State and local taxes may also be regarded as providing a subsidy to State and local governments, which are likely to find it somewhat easier to raise revenue because of the deduction. A general subsidy for spending by State and local governments can be justified only if the services which State and local governments provide have important spillover benefits to individuals in other communities. The existence of such benefits has not been documented.

Even if a subsidy for State and local government spending were desired, provision of the subsidy through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local governments gain less than fifty cents for every dollar of Federal revenue lost because of the deduction. Moreover, a deduction for State and local taxes provides a greater level of subsidy to high-income States and communities than to low-income States and communities. In addition, a deduction for taxes does not distinguish between categories of State and local spending on the basis of their spillover effects, but is as much a subsidy for spending on recreational facilities as for public welfare spending. Finally, the deduction distorts the revenue mix of State and local governments by creating a bias against the imposition of user charges in favor of more general taxes.

Proposal

The itemized deduction for State and local income taxes and for other State and local taxes that are not incurred in carrying on a trade or business or income-producing activity would be repealed. State and local taxes (other than income taxes) which currently are deductible only by itemizers, but which are incurred in carrying on an income-producing activity, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible subject to a threshold. See Ch. 4.01.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

While only one-third of all families itemized deductions in 1983, this group included most high-income families (more than 95 percent of families with income over $100,000 itemized tax deductions) and very few low-income families (2 percent of families with income of $10,000 or less itemized tax deductions). (Table 1.) Two-thirds of the total deductions for State and local tax payments were claimed by families with economic income of $50,000 or more. The benefits are even further skewed toward high-income families because deductions are worth more to families which face higher marginal tax rates.

The tax savings from deductibility vary widely among the States and, as shown in Table 2, provide the greatest benefits to individuals in high-income States. Because this tax expenditure requires tax rates for all individuals to be higher than they otherwise would be, those in the 15 States with above-average tax savings per capita currently gain at the expense of taxpayers in the other 35 States. Even within the high-tax States, less than one-half of all taxpayers itemize deductions.

Recent estimates indicate that the effect of tax deductibility on the level of State and local government spending is not large. A National League of Cities study found that total State and local spending is about 2% higher because of the existence of tax deductibility. This estimated effect is low in part because less than one-third of total State and local spending is financed by taxes potentially deductible from the Federal individual income tax. Because State and local spending has been growing by about 7% per year since 1980, the elimination of tax deductibility would not reduce the absolute level of State and local spending, but only reduce its rate of growth. However, because the proportion of taxpayers who itemize varies a great deal among the States as well as among local governments within a State, the effect on spending for a particular State or local government would be larger than 2 percent for a high-income community and may not affect spending at all in low-income communities where few residents itemize deductions.

The three most important sources of State and local tax revenue in the U.S. are general sales, personal income and property taxes. Some argue that itemized deductions should be eliminated for some of these taxes, but retained for others. As Table 3 shows, however, elimination of any one tax deduction would have an uneven effect on taxpayers among the States. In addition, since State and local governments would be likely to increase reliance on the remaining deductible taxes, disallowing deductions for particular taxes is likely to lead to sizeable distortions in State and local revenue mixes. For example, disallowing only the sales tax deduction might force a State, like Washington, that relies heavily on a general sales tax but does not have an individual income tax, to adopt one.

Table 3.09-1

Distribution of Deductions for Taxes Paid by Economic Income - 1983

Family Economic Income	Number of Families (thousands)	Percentage with State and Local Deduction	State and Local Taxes Deducted 1/ (millions)	Average Amount Deducted 2/
$ 0 - 9,999	337	2 %	$ 233	$ 691
10,000 - 14,999	516	4	465	901
15,000 - 19,999	1,009	9	1,009	1,089
20,000 - 29,999	3,894	22	5,307	1,363
30,000 - 49,999	10,820	51	22,012	2,034
50,000 - 99,999	11,298	80	36,408	3,223
100,000 - 199,999	1,793	95	12,150	6,776
200,000 or more	426	97	9,090	21,338
All Families	30,093	33	86,762	2,883

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1/ Net of income tax refunds.

2/ For families that itemize deductions.

Table 3.09-2

States Ranked by Per Capita Tax Savings from Tax Deductibility Under Current Law, 1982

State	Tax Savings Per Capita	Income Per Capita	Rank of Income Per Capita
New York	$233	$12,314	7
District of Columbia	198	14,550	2
Maryland	185	12,238	9
New Jersey	167	13,089	4
Delaware	162	11,731	14
California	155	12,567	5
Massachusetts	155	12,088	11
Minnesota	150	11,175	19
Michigan	144	10,956	22
Wisconsin	137	10,774	26
Connecticut	135	13,748	3
Oregon	117	10,335	31
Hawaii	116	11,652	15
Rhode Island	116	10,723	28
Virginia	113	11,095	20
Colorado	110	12,302	8
U.S. Average	106	11,107	-
Illinois	101	12,100	10
Utah	91	8,875	46
Georgia	87	9,583	37
Nebraska	87	10,683	29
Oklahoma	89	11,370	18
Pennsylvania	83	10,955	23
Ohio	82	10,677	30
Kansas	80	11,765	13
North Carolina	77	10,044	41
Arizona	76	10,173	32
Iowa	75	10,791	25
Vermont	75	9,507	39
South Carolina	73	8,502	49
Maine	70	9,042	42
Missouri	70	10,170	34
New Hampshire	68	10,729	27
Kentucky	65	8,934	44
Idaho	64	9,029	43
Washington	63	11,560	16
Nevada	57	11,981	12
Indiana	51	10,021	35
Florida	50	10,978	21
Alabama	49	8,649	48
Arkansas	49	8,479	50
Alaska	45	16,257	1
Texas	43	11,419	17
North Dakota	42	10,872	24
Montana	41	9,580	38
Mississippi	39	7,778	51
New Mexico	38	9,190	40
West Virginia	34	8,769	47
Tennessee	33	8,906	45
Wyoming	33	12,372	6
Louisiana	31	10,231	32
South Dakota	20	9,666	36

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Source: Advisory Commission on Intergovernmental Relations.

Table 3.09-3

Percentage Reliance on Different Deductible Taxes by States in 1982 1/

State	Property Taxes	General Sales Taxes	Individual Income Taxes
Alabama	19.8 %	50.7 %	29.5 %
Alaska	89.1	10.9	0
Arizona	38.7	42.4	18.9
Arkansas	31.6	37.4	31.0
California	33.1	37.3	29.6
Colorado	43.0	37.3	19.7
Connecticut	60.6	34.7	4.7
D.C.	34.0	24.8	41.2
Delaware	26.8	0	73.2
Florida	53.1	46.9	0
Georgia	35.3	34.6	30.1
Hawaii	22.8	51.8	25.5
Idaho	37.9	24.7	37.4
Illinois	47.2	31.1	21.7
Indiana	42.7	37.9	19.5
Iowa	50.5	20.8	28.7
Kansas	51.0	25.7	23.2
Kentucky	27.0	33.5	39.5
Louisiana	22.4	68.9	8.7
Maine	48.6	27.9	23.5
Maryland	33.9	18.9	47.2
Massachusetts	47.4	14.8	37.8
Michigan	53.1	20.2	26.7
Minnesota	36.5	23.0	40.5
Mississippi	30.5	57.1	12.4
Missouri	35.7	36.2	28.1
Montana	76.1	0	23.9
Nebraska	55.6	26.5	17.8
Nevada	33.0	67.0	0
New Hampshire	97.3	0	2.7
New Jersey	61.8	19.7	18.6
New Mexico	25.4	72.8	1.7
New York	40.2	23.3	36.5
North Carolina	33.0	27.4	39.6
North Dakota	52.2	38.5	9.3
Ohio	45.7	26.0	28.3
Oklahoma	26.2	42.0	31.8
Oregon	56.8	0	43.2
Pennsylvania	39.0	25.1	35.9
Rhode Island	54.0	22.1	23.9
South Carolina	32.6	33.8	33.6
South Dakota	56.8	32.2	0
Tennessee	37.2	60.8	1.9
Texas	55.7	44.3	0
Utah	33.5	39.2	27.3
Vermont	59.0	12.2	28.7
Virginia	40.6	22.7	36.7
Washington	40.8	59.2	0
West Virginia	22.2	55.8	22.0
Wisconsin	43.9	20.4	35.7
Wyoming	60.4	39.6	0
U.S. Average	42.5%	31.4%	26.2%

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1/ These figures include some general sales and property taxes with an initial impact on business rather than individuals. Certain other taxes can also be itemized deductions. Property, general sales, and individual income taxes accounted for 94 percent of total taxes itemized in 1982.

Source: Advisory Commission on Intergovernmental Relations.

ACCELERATE EXPIRATION OF CHARITABLE CONTRIBUTION DEDUCTION FOR NONITEMIZERS

General Explanation

Chapter 3.10

Current Law

Contributions to or for the benefit of religious, charitable, educational, and certain other tax-exempt organizations are deductible, subject to certain limitations. Prior to 1981 individuals who did not itemize their deductions could not deduct their charitable contributions. The Economic Recovery Tax Act of 1981 (ERTA) extended the charitable contribution deduction to nonitemizing taxpayers, phased in over a five-year period. For contributions made in the 1984 tax year, individuals who did not itemize deductions were permitted to deduct 25 percent of the first $300 of contributions made. For 1985 and 1986, the $300 limitation is removed, and the percentage of contributions deductible by nonitemizers is increased to 50 percent and 100 percent, respectively. Thus, under current law, the charitable contribution deduction will be allowed in full to nonitemizers in 1986. The charitable deduction for nonitemizers is scheduled to expire after 1986, however, so that after that time the deduction will again be unavailable to individuals who do not itemize their deductions.

Reasons for Change

Taxpayers are not subject to tax on their incomes up to the zero bracket amount (ZBA). This exemption generally is regarded as an allowance for certain personal expenses that ought not to be included in income and that all taxpayers are deemed to incur. In lieu of the ZBA, a taxpayer may itemize deductible personal expenses, such as certain medical expenses, interest expenses, and, prior to the ERTA changes, charitable contributions. Allowing a deduction for charitable contributions by nonitemizers in effect creates a double deduction for such contributions -- first through the ZBA, which is available only to nonitemizers, and second through the charitable contribution deduction.

In addition, the allowance of a charitable contribution deduction for nonitemizers is administratively burdensome for the Internal Revenue Service and complicated for taxpayers. In particular, it is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities; the expense of verification is out of proportion to the amounts of tax involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions with impunity. Moreover, taxpayers who claim charitable contribution deductions are required to maintain records substantiating those contributions. In the case of smaller gifts, the effort required to comply with the necessary substantiation requirements may be out of proportion to the amounts involved.

Finally, allowance of the deduction for nonitemizers would make it much more difficult to implement the proposed return-free system described in Ch. 5.01 for large numbers of taxpayers.

Proposal

The scheduled expiration date of the charitable contribution deduction for nonitemizers would be accelerated.

Effective Date

Expiration of the charitable contribution deduction for nonitemizers would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

There is little data indicating whether the charitable contribution deduction for nonitemizers has significantly increased the level of charitable giving. Because nonitemizers generally have lower incomes and thus lower marginal tax rates than itemizers, their contributions generally are not affected significantly by tax considerations. Rather, contributions made by nonitemizers are influenced far more by non-tax considerations such as general donative intent. Therefore, any adverse effect of the proposal on charitable giving is not expected to be significant, particularly in relation to the proposal's effect on tax revenues. The repeal of the charitable contribution deduction for nonitemizers is estimated to increase revenues in fiscal years 1986 and 1987 by $419 million and $2,687 million, respectively.

The proposal would simplify both the regular tax form (1040) and the short-form (1040A). The current deduction requires that a "worksheet" be included in the tax form instructions, on which the taxpayer makes calculations, the results of which are subsequently transferred onto Form 1040 or 1040A. The proposal would eliminate these computations and would relieve nonitemizers of recordkeeping burdens.

Part E. Tax Abuses--Mixed Business/Personal Use

Many expenses that involve significant personal consumption currently are being deducted as business expenses. This is unfair to taxpayers who do not have access to business perquisites and also distorts consumption choices. The proposals would limit deductions for entertainment, business meals, and travel expenses.

LIMIT DEDUCTION FOR ENTERTAINMENT AND BUSINESS MEAL EXPENSES

General Explanation

Chapter 3.11

Current Law

Ordinary and necessary expenses paid or incurred during a taxable year generally are deductible if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Although ordinary and necessary business expenses may include entertainment expenses, business entertainment expenses are deductible only if they satisfy certain additional requirements.

Business meals are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during, or after the meal. Expenses for other entertainment activities are deductible only if they are "directly related to" or "associated with" the taxpayer's trade or business. Entertainment activities are considered "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The taxpayer need not show that income actually resulted from the entertainment. In general, entertainment expenses satisfy the "associated with" standard if they are directly preceded or followed by a substantial and bona fide business discussion. A business discussion may be considered substantial and bona fide even if it consumes less time than the associated entertainment and does not occur on the same day as the entertainment activity.

Deductions for entertainment facilities, such as yachts, hunting lodges, or country clubs, used to entertain clients or customers also are subject to certain restrictions. A deduction is allowed for the portion of the cost of club memberships that are "directly related" to the taxpayer's business if the facilities are used primarily for business purposes. No deduction is allowed for other types of entertainment facilities. Tickets to sporting and theatrical events, and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting or theatrical event, however, are not considered to be expenses related to an entertainment facility. Thus, such expenses are fully deductible if they meet the "directly related to" or "associated with" tests for entertainment activities.

Business entertainment expenses also are subject to separate substantiation requirements. Deductions for entertainment expenses must be supported by records showing the amount of the expense, time and place of entertainment, business purpose of the expense, and business relationship to the taxpayer of any persons entertained.

Reasons for Change

In General. The subject of business entertainment expenses has received repeated legislative attention since 1962, when Congress first applied special restrictions to the deduction of such expenses. The continuing concern in this area reflects the difficulty of identifying the business component of expenses that have obvious personal benefits and are commonly incurred in nonbusiness contexts.

Although there are special restrictions on the deduction of business entertainment expenses, current law has largely maintained a facts and circumstances approach in determining whether entertainment expenses were incurred for business rather than personal purposes. The existing "directly related to" or "associated with" tests require investigation of a taxpayer's expectations and intentions. It frequently is possible under those tests to demonstrate an actual business purpose or connection for an entertainment expense that nevertheless has a strong, if not predominant, element of personal consumption. Thus, under present law, the costs of country club memberships, football and theater tickets, parties, and lunches and dinners at expensive restaurants are all deductible where a reasonable business connection can be demonstrated. Indeed, such deductions may be allowed even in cases where less time is devoted to business than to entertainment, no business is discussed, or the taxpayer is not even present at the entertainment activity.

The liberality of the law in this area is in sharp contrast to the treatment of other kinds of expenses that provide both business and personal benefits. In some cases, such as work-related clothing, the presence of any personal benefit is deemed sufficient reason to disallow any deduction. In other cases, taxpayers are allowed to deduct only the portion of expenses allocated to business. In contrast, present law often allows full deductibility of entertainment expenses that entail substantial personal consumption.

Fairness. The current treatment of business entertainment expenses encourages taxpayers to indulge personal entertainment desires while at work or in the company of business associates. The majority of taxpayers, however, do not benefit from this incentive. Most hold jobs that do not permit business entertainment, and many others are scrupulous in claiming business deductions for personal entertainment.

Current law thus creates a preference for the limited class of taxpayers willing and able to satisfy personal entertainment desires in a setting with at least some business trappings. Lunches are deductible for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site. The cost of tickets to a sporting event for friends of a business person is deductible if they are business associates, but the cost of tickets for friends of a secretary, sales clerk, or nurse must be paid for with after-tax dollars.

Extreme abuses of these deductions are commonly cited by those who assail the tax system as unfair. Such abuses may be limited to a relatively small number of taxpayers, but they nevertheless undermine the public trust that is essential in a tax system based on self-assessment. Taxpayers are not only aware of the abuses, they perceive an inability under current law to police them. Absent public confidence that the rules apply on the same basis to all, disrespect for the system and greater noncompliance are inevitable. The adoption of workable limitations on the deductibility of entertainment expenses would be an important step to preserve that confidence.

Efficiency. The treatment of "business related" entertainment under current law also encourages excessive spending on entertainment. The business person in the 40 percent marginal tax bracket considering whether to spend \$20 or \$50 on a "business meal" knows that the \$30 extra cost of the more expensive meal is reduced to \$18 because of the available deduction. The taxpayer's choice of meals is more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a nonbusiness context. Similarly, a business person in the 50 percent marginal tax bracket may conclude that it costs nothing extra to take a business associate to the theater even if it serves little or no business purpose. The attendance of the business associate permits a claim that the cost of both tickets is deductible, and thus the extra ticket may cost nothing on an after-tax basis.

Present law has no effective response to these practices because it characterizes an entertainment expense as business or personal on the basis of the taxpayer's intentions and purposes. Once a business purpose or connection is established, it ordinarily permits the entire expense to be deducted, even though the total amount spent reflects what is in essence a choice about the level of personal consumption.

Proposals

1. No deduction would be allowed for entertainment activity expenses. Entertainment activity expenses, however, would be exempted from the general disallowance rule if they: are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; constitute recreational expenses for employees (e.g., Christmas parties and summer outings); are expenses for goods, services, and facilities made available to the general public (e.g., samples and promotional activities); or are expenses includable in income of persons who are not employees.

2. A deduction would be allowed for the cost of ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). To the extent the total cost of a

business meal exceeds $25 times the number of persons participating in such meal, 50 percent of such excess would be nondeductible. The meal cost limitation would include gratuities and tax with respect to the meal. However, expenses for food and beverage furnished on the business premises of the taxpayer primarily for employees of the taxpayer would not be subject to the limitation.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

Business Meal Limitations. Business meals provide a mixture of business and personal benefits. The extent to which a meal provides a personal benefit will vary, and it is not possible to develop rules that would specify the precise percentage of personal benefit in individual cases. The proposal, therefore, establishes a relatively mechanical limitation on the deductibility of business meals, targeted at meal expenses that are most likely to provide a significant level of personal consumption. The $25 allowance is intentionally quite generous and is intended to provide a full deduction for the vast majority of business meals. The deduction will be disallowed only for 50 percent of the portion of the cost of a business meal that is in excess of $25.

Representatives of the restaurant industry in testimony before Congress have provided several estimates of the average cost of restaurant meals. If adjusted for inflation, those estimates would range between $7.50 and $11.50 for 1986. In addition, Census data shows that only about 2.5 percent of all restaurant meals in 1977 were in restaurants where the average bill exceeded $10.00. Adjusted for inflation, this suggests that only about 2.5 percent of all meals were in restaurants with average bills over $19.00 in 1986. Recent surveys suggest that less than 15 percent of all business meals would be affected by the proposal in 1986.

While the proposal will reduce the number of expensive business meals, it is expected that the limitations will not have a significant impact on more than five percent of restaurants. Moreover, since some high-cost meals will be replaced by moderate-cost meals, the effect on total employment in the restaurant industry is expected to be modest.

Businesses currently are required to keep detailed records for all deductible meals. Therefore, the additional recordkeeping costs should be minimal.

Placing a limit on the deductibility of business meals would eliminate the extreme cases of abuse -- those that offend the average taxpayer the most. Despite its small revenue effect, the proposal would be of significant assistance in restoring trust in the tax system.

The Elimination of Other Entertainment Deductions. The proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues. Because all such entertainment has a large personal component, the proper tax treatment, on both efficiency and equity grounds, is to disallow a deduction.

Approximately one-third of all baseball tickets and over one-half of all hockey tickets are purchased by businesses. The net effect is often to raise the cost of tickets for those who are not subsidized through the tax system for their purchases. Some performing arts organizations also sell large proportions of their tickets to businesses. Some tickets bought by businesses would remain deductible if the tickets are made available to the general public as a promotion under current law standards.

LIMIT DEDUCTION FOR TRAVEL EXPENSES

General Explanation

Chapter 3.12

Current Law

Travel expenses incurred by a taxpayer while "away from home" are deductible if such expenses are reasonable and necessary in the taxpayer's business and are directly attributable to the taxpayer's business. Travel expenses may include the cost of travel to and from the destination and the cost of meals, lodging, and other incidental travel costs (e.g., laundry, taxi fares) incurred while at the business destination. A taxpayer's "home" for purposes of the deduction is generally his or her business headquarters. A taxpayer is considered to be "away" from his or her business headquarters only if the travel involves a "temporary" rather than an "indefinite" assignment at another location. If a taxpayer accepts a job at a distant location for an indefinite period, the new job location becomes the taxpayer's tax home. Temporary employment generally is expected to last for a short or foreseeable period of time, but whether employment is temporary or indefinite is essentially a factual question.

The costs of attending a convention or other meeting (including the costs of meals and lodging) in the North American area are deductible if the taxpayer is able to show that attendance at the convention is directly related to his or her trade or business and that such attendance is advancing the interests of the taxpayer's trade or business. The North American area includes the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada, Mexico, and certain Caribbean countries that have entered into exchange of tax information agreements with the United States. A stricter rule applies for conventions held outside the North American area. In order to claim a deduction for the costs of attending such a convention, a taxpayer also must show that it was "as reasonable" for the meeting to be held outside the North American area as within it.

Deductions for conventions, seminars, or other meetings held on cruise ships are subject to additional limitations. No deduction is allowed unless the cruise ship is registered in the United States and stops only at ports of call in the United States or in possessions of the United States. In any event, a taxpayer may deduct no more than $2,000 for such meetings per year.

Professional education expenses, including travel as a form of education, are deductible if the education maintains or improves existing employment skills or is required by an employer, or applicable law or regulation. To be deductible, the travel must be directly related to the duties of the taxpayer in his or her employment or other trade or business. The deductible educational travel may occur while the taxpayer is on sabbatical leave.

Reasons for Change

The present limitations on deductions for business travel fail to distinguish adequately between costs incurred for business purposes and costs reflecting personal consumption. The deduction for expenses for meals and lodging incurred "away from home" is premised on the assumption that the business traveler incurs additional costs while away from home. Restaurant meals are likely to be more expensive than the cost to the taxpayer of eating at home, and hotel accomodations are a duplicative expense for the taxpayer who maintains regular living quarters elsewhere. These excess costs incurred by a taxpayer away from home may reasonably be treated as legitimate business expenses.

Extended travel status, however, generally permits economies not available on shorter trips. The temporary residence of a taxpayer expecting to be away from home for a year or more typically will have kitchen, laundry, and other facilities that permit the taxpayer to avoid excess expenses. Moreover, extended travel may permit the taxpayer to abate fixed costs associated with his permanent residence, such as by renting or subletting his house or apartment.

In addition, the current tax treatment of travel that has both business and personal elements creates opportunities for abuse that threaten public confidence in the system. Current law largely retains a facts and circumstances approach to the characterization of such mixed motive expenses, and thus requires investigation of the taxpayer's particular intentions and expectations. The fact that a plausible business purpose frequently can be established for travel that has a strong personal component encourages taxpayers, in a system of self-assessment, to take aggressive reporting positions. The great majority of taxpayers are honest, and apply current law standards in good faith. It is not reasonable, however, to expect that taxpayers deny themselves the benefit of the doubt when applying rules that are broad and open to interpretation.

The issues identified above are characteristic of a system that emphasizes fairness of individual results, and thus avoids the rougher justice achieved by mechanical, bright-line rules. Without challenging these priorities in any fundamental way, it is still appropriate to recognize that the integrity of the system ultimately depends on rules that taxpayers respect and perceive that others respect. This is especially so with regard to deductions for expenses, such as travel, that most taxpayers undertake strictly for personal purposes and that have obvious personal consumption benefits. Accordingly, strict limitations on deductions for travel expenses are appropriate where the component of personal consumption is manifest or where business and personal motivations are so intertwined as to be inseparable.

Proposals

1. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and no travel deductions would be allowed.

2. No deduction would be allowed for business travel by ocean liner, cruise ship, or other form of luxury water transportation in excess of the cost of otherwise available business transportation, unless the taxpayer provides proof of existing medical reasons for utilizing such transportation.

3. No deduction would be allowed for expenses paid with respect to conventions, seminars, or other meetings held aboard cruise ships.

4. No deduction would be allowed for travel as a form of education.

5. The limitations set forth in 2. through 4. above would not apply in cases where the expenses in question are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; or are expenses includable in income of persons who are not employees.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposed limitations on certain travel expense deductions are designed to restrict deductions for travel expenses where personal consumption benefits are most evident without unduly restricting deductions for legitimate business expenses.

The one-year rule for defining temporary employment would eliminate a significant source of dispute between taxpayers and the Internal Revenue Service, and would provide a reasonable division between temporary and indefinite assignments. One year's stay at a single location is sufficient to indicate that regular living patterns will be established at the new location and, thus, that food and lodging expenses need not be duplicative of or more expensive than comparable costs at the original job site.

The disallowance of a deduction for the cost of travel by cruise ships, ocean liner, or other form of luxury water transportation in excess of the cost of otherwise available business transportation is intended to deny a deduction for the portion of the travel cost most likely to constitute personal rather than business benefit.

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Part F. Tax Abuses--Income Shifting

Although the proposed rate schedule for individuals is flatter than under current law, there would remain a substantial difference between the top and bottom rates. Thus, as under current law, taxpayers subject to the top rate would have an incentive to shift income to their children or other family members subject to tax at lower rates. Current law limits income shifting through various rules, including the assignment-of-income doctrine and the interest-free loan provisions. This Part discusses proposed rules that would buttress current limits on income-shifting by preventing taxpayers from reducing the tax on unearned income by transferring income to minor children or establishing trusts.

ADJUST TAX RATE ON UNEARNED INCOME OF MINOR CHILDREN

General Explanation

Chapter 3.13

Current Law

Minor children generally are subject to the same Federal income tax rules as adults. If a child is claimed as a dependent on another taxpayer's return, however, the child's zero bracket amount is limited to the amount of the child's earned income. Accordingly, the child must pay tax on any unearned income in excess of the personal exemption ($1,040 in 1985).

Under current law, when parents or other persons transfer investment assets to a child, the income from such assets generally is taxed thereafter to the child, even if the transferor retains significant control over the assets. For example, under the Uniform Gifts to Minors Act ("UGMA"), a person may give stock, a security (such as a bond), a life insurance policy, an annuity contract, or money to a custodian, who generally may be the donor, for the child. As a result of the gift, legal title to the property is vested in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income. Results similar to those achieved by a transfer under the UGMA may be obtained by transferring property to a trust or to a court-appointed guardian.

Parents also may shift income-producing assets to a child, without relinquishing control over the assets, by contributing such assets to a partnership or S corporation and giving the child an interest in the partnership or corporation.

Reasons for Change

Under current law, a family may reduce its aggregate tax liability by shifting income-producing assets among family members. Such "income shifting" is a common tax-planning technique, typically accomplished by the parents transferring assets to their children so that a portion of the family income will be taxed at the child's lower marginal tax rate.

Income shifting undermines the progressive rate structure, and results in unequal treatment of taxpayers with the same ability to pay tax. A family whose income consists largely of wages earned by one or both parents pays tax on that income at the marginal rate of the parents. Even though such wage income is used in part for the living expenses of the children, parents may not allocate any portion of their salary to their children in order that it be taxed at the children's lower tax rates. Families with investment income, however, may be financially able to transfer some of it to the children, thereby shifting the income to lower tax brackets. Typically, this ability is most prevalent among wealthy taxpayers. Moreover, use of a trust or a gift under the UGMA allows the parents to achieve this result without relinquishing control over the property until the children come of age.

The opportunity for income shifting also complicates the financial affairs of persons who take advantage of it, and causes some persons to make transfers they would not make absent tax considerations. Disputes with the Internal Revenue Service are created in the case of transfers that arguably are ineffective in shifting the incidence of taxation to the transferee, such as when a parent nominally transfers property to children but in reality retains the power to revoke the transfer.

Proposal

Unearned income of children under 14 years of age that is attributable to property received from their parents would be taxed at the marginal tax rate of their parents. This rule would apply only to the extent that the child's unearned income exceeded the personal exemption ($2,000 under the Administration proposals). The child's tax liability on such unearned income would be equal to the additional tax that his or her parents would owe if such income were added to the parents' taxable income and reported on their return. If the parents report a net loss on their return, the proposed rule would not apply, and the child's unearned income would be taxed along with his or her earned income. If more than one child has unearned income which is taxable at the parents' rate, such income would be aggregated and added to the parents' taxable income. Each child would then be liable for a proportionate part of the incremental tax.

All unearned income of a child would be treated as attributable to property received from a parent, unless the income is derived from a qualified segregated account. A child who receives money or property from someone other than a parent, such as another relative, or who earns income, could place such property or earnings into a qualified segregated account. Property received by reason of the death of a parent could also be placed into the account. However, other amounts otherwise received directly or indirectly from a parent could not be placed into the account.

For purposes of this provision, an adopted child's parents would be the adoptive parent or parents. In the case of a foster child, the parents would be either the natural parents or the foster parents, at the child's election. If the parents are married and file a joint return, the child's tax would be computed with reference to the parents' joint income. If the parents live together as of the close of the taxable year, but do not file a joint return (i.e., if they are married and file separate returns or if they file as single individuals), then the child's tax would be computed with reference to the income of the parent with the higher taxable income. If the parents do not file a joint return and are not living together as of the close of the taxable year, the child's tax would be computed with reference to the income of the parent having custody of the child for the greater portion of the taxable year.

Expenses that are properly attributable to the child's unearned income would be allowed as deductions against such income. Itemized deductions and the personal exemption generally would be allocated between earned and unearned income in any manner chosen by the taxpayer. Interest expense, however, would be deductible against unearned income that is taxable at the parents' tax rate only if it is attributable to debt that was assumed by the child in connection with a transfer of property from the parents, or to debt that encumbered such property at the time of the transfer.

Earned income and income from a qualified segregated account would be taxable (after subtracting the portion of the child's itemized deductions and personal exemption allocated to such income) under the rate schedule applicable to single individuals, starting at the lowest rate. Moreover, unlike current law, the zero bracket amount could be used against both the child's earned income and unearned income from a segregated account, although it could not be used to offset other unearned income.

The proposed taxation of income of children under 14 years of age may be illustrated by the following example.

Suppose Sarah, aged 13, earns $500 from a paper route in 1984. She has $4,000 in a bank account, attributable to savings from her earned income and gifts from her grandparents. She earns $360 in interest from the account. She also earns $1,000 from an account set up by her parents under the Uniform Gifts to Minors Act. Under current law, Sarah's unused zero bracket amount is $2,300 less $500, or $1,800. This amount must be added to her income. Thus, Sarah's income is:

$ 500
360
1,000
1,800
$3,660, less $1,000 personal exemption = $2,660.

In 1984, the tax on taxable income of $2,660 is $39.60. Sarah must file a return and pay this tax.

Under the proposal (assuming 1984 levels of the zero bracket amount and personal exemption), Sarah would not have to file a return, because her income taxable at her parents' rate ($1,000) is not in excess of her personal exemption, and her other income ($860) is not in excess of the zero bracket amount. If her parents placed more money in her name she would have to file a return. Even then, however, only one rate would apply to her income, namely that of her parents.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help to ensure the integrity of the progressive tax rate structure, which is designed to impose tax burdens in accordance with each taxpayer's ability to pay. Families would be taxed at the rate applicable to the total earned and unearned income of the parents, including income from property that the parents have transferred to the children's names. The current Federal income tax incentive for transferring substantial amounts of investment property to minor children would be eliminated.

Under the proposal, the unearned income of a minor child under 14 years of age would be taxed at his or her parents' rate. This is the age at which children may work in certain employment under the Fair Labor Standards Act. Because most children under 14 have little or no earned income, maintenance of segregated accounts and preparation of their returns under the proposal should not be complex.

In most cases the income tax return of a child under 14 years of age is prepared by or on behalf of the parent and signed by the parent as guardian of the child. In such cases, the requirement that a child's income be aggregated with that of his or her parents would not create a problem of confidentiality with respect to the parents' return information, since there would be no need to divulge this information to the child. Although the return generally would be filed by a parent on behalf of a child, liability for the tax would rest, as under current law, on the child.

Only children required to file a return under current law would be required to do so under the proposal. In 1981, only 612,000 persons who filed returns reporting unearned income were claimed as dependents on another taxpayer's return. This represents less than one percent of the number of children claimed as dependents in that year. Moreover, in many instances the proposal would eliminate tax liability for children who currently must file a return because they cannot use the zero bracket amount to offset unearned income that is not attributable to property received from their parents.

REVISE GRANTOR AND NON-GRANTOR TRUST TAXATION

General Explanation

Chapter 3.14

Current Law

In General

The manner in which the income from property held in trust is taxed depends upon the extent to which the grantor has retained an interest in the trust. A so-called "grantor trust," a trust in which the grantor has retained a statutorily defined interest, is treated as owned by the grantor and the trust's income is taxable directly to the grantor. Non-grantor trusts, including "Clifford trusts," on the other hand, are treated as separate taxpayers for Federal income tax purposes, with trust income subject to a separate graduated rate structure.

The rules for determining whether a trust will be treated as a grantor trust are highly complex. In general, however, the test is whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. For example, to the extent that the grantor (or a party whose interests are not adverse to the grantor) has the right to vest the trust's income or assets in the grantor, the trust will be treated as a grantor trust. Similarly, to the extent that the trust's assets or income may reasonably be expected to revert to the grantor within ten years of the trust's creation, the trust will generally be treated as a grantor trust.

In general, the income of a non-grantor trust is subject to one level of tax; it is taxable either to the trust itself or to the beneficiaries of the trust. Under this general model, trust income is included as gross income of the trust, but distributions of such income to trust beneficiaries are deductible by the trust and includable in the income of the beneficiaries.

The maximum distribution deduction permitted to a trust, and the maximum amount includable in the income of trust beneficiaries, is the trust's distributable net income ("DNI"). A trust's DNI consists of its taxable income computed with certain modifications, the most significant of which are the subtraction of most capital gains and the addition of any tax-exempt income earned by the trust.

To the extent that a trust distribution carries out DNI to a beneficiary, the trust essentially serves as a conduit, with the beneficiary taking into account separately his or her share of each trust item included in DNI. Under a complex set of rules, the computation of each beneficiary's share of an item of trust income generally depends upon the amount distributed to the beneficiary and the "tier" to which the beneficiary belongs. A distribution that does not carry out DNI -- such as one in satisfaction of a gift or bequest of specific property or a specific sum of money, or one in excess of DNI -- is not deductible by the trust and is not includable in the recipient's income. Similarly, because capital gains generally are excluded from the computation of DNI, a trust ordinarily is subject to taxation on the entire amount of its capital gain income even when it distributes an amount in excess of its DNI.

Adoption of Taxable Year

The trustee of a non-grantor trust may select a year ending on the last day of any month as the trust's taxable year. Although a trust distribution that carries out DNI is generally deductible by the trust in the taxable year during which it is made, the distribution is not taxable to the beneficiary until his or her taxable year with which or in which the trust's taxable year ends. Thus, for example, if an individual is a calendar-year taxpayer and is the beneficiary of a trust with a taxable year ending January 31, distributions made by the trust with respect to its year ending January 31, 1984, will not be subject to tax until the beneficiary's year ending December 31, 1984, even if they were made as early as February 1983.

Throwback Rules

The so-called "throwback rules" are applicable only to trusts that accumulate income rather than distribute it currently to the beneficiaries. These rules limit the use of a trust as a device to accumulate income at a marginal tax rate lower than that of the trust's beneficiaries. DNI that is accumulated rather than distributed currently becomes undistributed net income ("UNI") and may be subject to additional tax when distributed to the beneficiaries.

The rules for determining the amount, if any, of such additional tax are complex. In general, however, if a trust's current distributions exceed its DNI and the trust has UNI from prior taxable years, the excess distributions (to the extent of UNI), increased by the taxes paid by the trust on such distribution, will be taxed at the beneficiary's average marginal tax rate over a specified period preceding the distribution as reduced by a credit for the tax paid by the trust on such distribution.

Reasons for Change

Taxpayer Fairness

Present law permits a grantor to shift income to family members through creation of a trust, even when the grantor retains significant control over or a beneficial interest in the trust's assets. For example, trust income is not taxed to the grantor even though the trust's assets will revert to the grantor as soon as ten years after the trust's creation. Similarly, trust income is not taxed to the grantor even though the grantor appoints himself or herself as trustee with certain discretionary powers to accumulate income or distribute trust assets. Significantly broader discretion over trust income and distributions may be vested in an independent trustee, who, although not formally subject to the grantor's control, may be expected to exercise his or her discretion in a manner that minimizes the aggregate tax burden of the trust's grantor and beneficiaries.

During the lifetime of the grantor, there is no persuasive justification for taxing a trust under its own graduated rate schedule. Permitting a grantor to create trusts and thereby obtain the benefit of multiple graduated rate schedules is inconsistent with the principle that all income of an individual taxpayer should be subject to tax under the same progressive rate structure. A trust is simply an arrangement established by the grantor to manage investment assets and to allocate the income from those assets to beneficiaries. Where the grantor has effectively divested himself of control and enjoyment of trust income is irrevocably fixed or determined, such income should be taxed to the beneficial owners of the trust. Where this divestment has not taken place, however, the trust's income should be included in the grantor's income or taxed at the grantor's marginal tax rate.

On the other hand, after the grantor's death it may not be unreasonable to respect trusts as separate taxable entities. In such instances, it is likely that non-tax factors outweigh any Federal income tax considerations in the grantor's decision whether to create a trust. For example, it is reasonable to assume that a grantor creating an inter vivos trust with discretion in the trustee over the ultimate beneficiary of the property is creating the trust, at least in substantial part, to obtain preferential income tax treatment; ordinarily, the grantor could accomplish most of the non-tax objectives for the creation of the trust by retaining the property. At the least, the tax system should not create a preference for utilizing the trust vehicle. In contrast, a trust may be the only form in which to preserve such discretion and flexibility after the grantor's death. Precise rules that would define when post-death trusts would be granted the benefit of separate graduated rate schedules would be complex and would lead to harsh results in many cases.

Efficiency and Simplification

The significant income-splitting advantages that may be gained by placing income-producing assets in trust have resulted in greater utilization of the trust device than would be justified by non-tax economic considerations. Moreover, even where there are non-tax reasons for a trust's creation, tax considerations heavily influence the trustee's determination of whether to accumulate or distribute trust income. No discernable social policy is served by this tax incentive for the creation of trusts and the accumulation of income within them. Thus, current tax policy has not only sacrificed tax revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property. In addition, the fact that the tax benefits of the trust form can be increased through the creation of multiple trusts has resulted in the creation of numerous trusts with essentially similar dispositive provisions.

The tax advantages that current law provides to trusts also have spawned a complex array of anti-abuse provisions. The grantor trust rules and the throwback rules are highly complex and often arbitrary in their application. Rules that attribute capital gain of certain non-grantor trusts to the grantor are also complex in operation and can have unforeseen consequences to trust grantors.

Proposal

Taxation of Trusts During Lifetime of Grantor

1. Overview

During the lifetime of the grantor, all trusts created by the grantor would be divided into two categories: trusts that are treated as owned by the grantor for Federal income tax purposes, because the grantor has retained a present interest in or control over the trust property; and trusts that are not treated as owned by the grantor, because the grantor does not have any present interest in or control over the property. As under current law, the income of a trust classified as a grantor-owned trust generally would be taxed directly to the grantor to the extent that the grantor is treated as the owner. A non-grantor-owned trust generally would be respected as a separate taxable entity. During the grantor's lifetime, however, income would be taxed to the trust at the grantor's marginal tax rate, unless the trust instrument requires the income to be distributed to or irrevocably set aside for specified beneficiaries.

2. Grantor-owned trusts

The grantor would be treated as the owner of a trust to the extent that (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be characterized as "adverse parties" under present law. In addition, a United States person who transfers property to a foreign trust having one or more U.S. beneficiaries would continue to be treated as the owner of the portion of the trust attributable to that property to the extent required under present law.

The present law rules under which a person other than the grantor may be treated as owner of a trust would be retained and made consistent with these rules. A grantor or other person who is treated as the owner of any portion of a trust under these rules would be subject to tax on the income of such portion. Transactions between the trust and its owner would be disregarded for Federal income tax purposes where appropriate.

3. <u>Non-grantor-owned trusts</u>

(a) <u>In general</u>. A trust that is not treated as owned by the grantor or by any other person under the rules described above would be subject to tax as a separate entity. Unlike present law, however, non-grantor-owned trusts would be required to adopt the same taxable year as the grantor, thereby limiting the use of fiscal years by trusts to defer the taxation of trust income.

The trust would compute its taxable income in the same manner as an individual, but would not be entitled to a zero bracket amount or a personal exemption (or deduction in lieu of a personal exemption). As under current law, the trust would be entitled to a deduction for charitable contributions made within 65 days of the close of the trust's taxable year.

(b) <u>Distribution deduction</u>. The present rules regarding the deductibility of distributions made by a trust to non-charitable beneficiaries would be substantially changed. First, during the lifetime of the grantor, only mandatory distributions would be deductible by a trust. A distribution would qualify for this deduction only if a fixed or ascertainable amount of trust income or property is required to be distributed to a specific beneficiary or beneficiaries. As under present law, distributions required to be made would be deductible regardless of whether actually made by the trustee.

The amount of a mandatory distribution would be considered fixed or ascertainable if expressed in the governing instrument as a portion or percentage of trust income. The requirement that each beneficiary's share be fixed or ascertainable also would be satisfied by a requirement that distributions be made on a per capita or per stirpital basis that does not give any person the right to vary the beneficiaries' proportionate interests. Thus, distributions would not qualify as mandatory if the governing instrument requires the distribution of all income among a class of beneficiaries, but gives any person the right to vary the proportionate interests of the members of the class in trust income.

A distribution would be considered mandatory if required upon the happening of an event not within the control of the grantor, the grantor's spouse, or the trustee, such as the marriage of a beneficiary or the exercise by an adult beneficiary of an unrestricted power of withdrawal. The requirement that the governing instrument specify the beneficiary or beneficiaries of a mandatory distribution would be satisfied if a class of beneficiaries were specified and particular beneficiaries could be added or removed only upon the happening of certain events not within the control of the grantor, grantor's spouse, or trustee, such as the birth or adoption of a child, marriage, divorce, or attainment of a certain age.

Second, unlike present law, property required to be irrevocably set aside for a beneficiary would be treated as a mandatory distribution, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, or is subject to a power exercisable by the beneficiary the possession of which will cause the property to be included in the beneficiary's gross estate for Federal estate tax purposes. Thus, the trustee could designate property as irrevocably set aside for a beneficiary and obtain a distribution deduction (provided that a distribution or set-aside is mandatory under the governing instrument) without making an actual distribution to the beneficiary. To qualify for the set-aside deduction, the beneficiary would have to agree to include the amount in income.

If the tax imposed on a beneficiary by reason of a set-aside exceeds the amount actually distributed to the beneficiary in any year, and if the governing instrument permits the beneficiary to obtain a contribution from the trustee equal to the tax liability imposed by reason of the set-aside (less any amounts previously distributed to the beneficiary during the taxable year), such contribution would be treated as paid out of the amount set aside, and therefore would not carry out additional DNI. This structure, unlike present law, would permit a fiduciary to obtain the benefit of a beneficiary's lower tax bracket through an irrevocable set-aside. Accordingly, tax motivations would not override non-tax factors which might indicate that an actual distribution is undesirable.

Third, whether mandatory or not, distributions to non-charitable beneficiaries would not be deductible during the lifetime of the grantor under the following circumstances indicating incomplete relinquishment of interest in or dominion and control over the trust:

(i) If any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse;

(ii) If any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or the funding of the trust;

(iii) If any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a non-fiduciary capacity without the consent of a fiduciary;

(iv) If and to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or

(v) If trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.

(c) Computation of tax liability. Once the taxable income of a non-grantor inter vivos trust has been computed under the rules described above, the trust's tax liability would be determined. This liability would be the excess of (i) the tax liability that would have been imposed on the grantor had the trust's taxable income been added to the greater of zero or the grantor's taxable income and reported on the grantor's return, over (ii) the tax liability that is actually imposed on the grantor. Thus, the trust's tax liability generally would equal the incremental amount of tax that the grantor would have paid had the trust been classified as a grantor trust, with two exceptions. First, to avoid the difficulty associated with any recomputation of a grantor's net operating loss carryover and other complexities, if the grantor has incurred a loss in the taxable year or in a prior taxable year, such loss would be disregarded and the grantor would be deemed to have a taxable income of zero for purposes of computing the trust's tax liability. Second, the addition of the trust's taxable income to the taxable income of the grantor would not affect the computation of the grantor's taxable income. For example, trust income would not be attributed to the grantor for purposes of determining the grantor's floor on various deductions.

If the grantor has created more than one non-grantor trust, then each such trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income. If one or more trusts do not cooperate with the grantor and other trusts created by the grantor in determining their tax liability under these rules, the trusts failing to cooperate would be subject to the highest marginal rate applicable to individuals. Similarly, if the grantor does not provide a trustee with information sufficient to enable the trustee to compute the trust's tax liability under these rules, the trustee would be required to assume (for purposes of computing the trust's tax) that the grantor had taxable income placing him or her in the highest marginal rate.

(d) Taxation of beneficiaries. As under current law, distributions to beneficiaries that are deductible by a trust would be taxable to the beneficiaries, with the trust's DNI representing the maximum amount deductible by the trust and includable in the income of the beneficiaries. Capital gain deemed to be distributed would be included in the computation of the trust's DNI. Capital gain income would be deemed to be distributed if the trust instrument requires that it be distributed or if and to the extent that mandatory distributions and set-asides exceed DNI (as computed without regard to such gain). Each recipient of a required distribution or set-aside would take into account his or her proportionate share of DNI. Thus, the tier rules of present law would be eliminated. Each item entering the computation of DNI, including capital gains that are deemed to be distributed and hence are included in DNI, would be allocated among the beneficiaries and the trust, based on the proportionate amounts distributed to or set aside for each beneficiary.

(e) Multiple grantors. For purposes of determining whether the grantor is the owner of any portion of a trust, and for purposes of determining whether a mandatory distribution is deductible, a trust having more than one grantor would be treated as consisting of separate trusts with respect to each grantor. If a husband and wife are both grantors with respect to a trust, however, they would be entitled to elect one of them to be treated as the grantor with respect to the entire trust for all Federal income tax purposes, such as determining the marginal rate of the trust and the treatment of the trust as a lifetime or post-death trust. The election would have to be made on the trust's first income tax return. Once made, such an election would be irrevocable and would apply to all subsequent transfers to such trust made during the course of the marriage by either spouse.

Taxation of Trusts After Death of Grantor

For all taxable years beginning after the death of an individual, all inter vivos and testamentary trusts established by such individual would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and with a distribution deduction for all distributions, whether mandatory or discretionary, actually made to or for non-charitable beneficiaries. As under present law, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. A similar rule would apply to set-asides. Charitable contributions would be deductible as under current law. All trusts would compute DNI in the same manner as non-grantor inter vivos trusts. Any taxable income of the trust would be subject to tax under a graduated rate schedule which is the same as that for married individuals filing separately.

In order to prevent the use of such post-death trusts as income-splitting devices, the throwback rules of present law would continue to apply. Because the present throwback rules often do not fully recapture the tax savings from the accumulation of income within the trust, consideration would be given to provisions such as the imposition of an interest charge on the tax payable with respect to an accumulation distribution and the application of the throwback rules to income accumulated while the beneficiary is under 21 years of age and to capital gain income. In addition, consideration would be given to a more restrictive multiple trust rule to limit the tax benefits of the trust form where two or more trusts have any common primary beneficiaries.

In order to simplify the transition of inter vivos trusts to the post-death rules and to achieve consistent treatment with the decedent's estate (see Ch. 3.15), a trust created during the grantor's lifetime would continue to be treated as an inter vivos trust through the end of the taxable year in which the grantor's death occurs. Thus, for the taxable year in which the grantor's death occurs, income of a grantor-owned trust would be taxed to the grantor. Similarly, during the grantor's final taxable year, a non-grantor-owned inter vivos trust would compute its taxable income in the same manner as before the death of the grantor. Accordingly, such a trust would be entitled to a deduction for qualifying distributions to charity and for all mandatory distributions or set-asides with respect to non-charitable beneficiaries. The trust's taxable year would not terminate with the death of the grantor and the trust would compute its tax liability for the grantor's final year by reference to the taxable income of the grantor.

Testamentary trusts would compute their income using the same taxable year as the decedent and the decedent's estate. A testamentary trust created before the end of the taxable year of the decedent's death would compute its tax liability for its first (short) taxable year along with all other trusts created by the decedent, by reference to the decedent's taxable income for that year.

Effective Date

The proposal would apply generally to irrevocable trusts created after 1985 and to trusts that are revocable on January 1, 1986, for taxable years beginning on or after January 1, 1986. A trust that is irrevocable on January 1, 1986, would nevertheless be treated as created after 1985 if any amount is transferred to such trust by a grantor after such date. Similarly, a trust that is revocable on January 1, 1986, and that becomes irrevocable after such date would be treated as a new trust for purposes of these rules.

For trusts that are irrevocable on January 1, 1986, the proposal would apply according to the following rules. Trusts that are grantor trusts under present law would be subject to the new rules beginning with the first taxable year of the grantor that begins on or after January 1, 1986. If a trust that is classified as a grantor trust under present law is classified as a non-grantor trust under the new rules, however, it would be entitled to elect to be treated as if the grantor were the owner for Federal income tax purposes (such election to be made jointly by the grantor and the trustee).

With respect to trusts that are irrevocable on January 1, 1986, and are not classified as grantor trusts under present law, the proposal would apply to taxable years beginning on or after January 1, 1986, with the following exceptions. First, if such a trust has already validly elected a fiscal year other than the grantor's taxable year on a return filed before January 1, 1986, the trust would be entitled to retain that year as its taxable year. In a case where the grantor and the trust have different taxable years, the trust would compute its tax liability by reference to the grantor's income for the grantor's taxable year ending within the taxable year of the trust. Second, such trusts would be entitled to a distribution deduction for all distributions and set-asides, whether discretionary or mandatory, made during the grantor's lifetime. Finally, such trusts would be entitled to elect to continue the tier system of present law for allocating DNI among trust beneficiaries.

Analysis

The proposal would limit the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

The proposal would, in general, permit the use of non-grantor inter vivos trusts to shift income among family members only if distributions or set-asides are mandatory and only if the grantor has effectively relinquished all rights in the trust property (other than the exercise of certain powers as trustee). With respect to such a trust, present law would be liberalized in that amounts irrevocably set aside for a beneficiary would be treated as actually distributed. At the same time, wholly discretionary distributions would be ineffective to shift income to trust beneficiaries regardless of the identity of the trustee.

The proposal also would result in substantial simplification of the rules for taxation of trust income. The tier system and the special rule taxing some trust capital gains to the grantor would be repealed. The throwback rules would no longer be applicable to any trust income accumulated during the grantor's lifetime after 1985. Similarly, it would not be necessary to apply the multiple trust rules until after the year in which the grantor's death occurs. Requiring virtually all new trusts to use a calendar year would eliminate the unwarranted tax advantage often created by the selection of fiscal years. The simplicity created by these rules would more than offset whatever complexity is created by taxing inter vivos trusts at the grantor's marginal rate in certain circumstances.

The removal of the artificial tax advantages of trusts would cause decisions regarding the creation of trusts to be based on non-tax considerations. For example, because the income of a ten-year "Clifford" trust would be taxed at the grantor's marginal rate with no distribution deduction, such trusts would be created only where warranted by non-tax considerations. Because many inter vivos trusts are created solely for tax reasons, fewer such trusts would be established under the proposed rules, thus simplifying the financial affairs of taxpayers and reducing the number of trust income tax returns that have to be filed. At the same time, however, the proposal would not impose a tax penalty on the use of a trust to hold and to manage a family's assets. As a general rule, during the grantor's lifetime, accumulated trust income would be taxed as if the grantor had not established the trust. After the grantor's death, a more liberal treatment allowing a graduated rate schedule to the trust would apply. This treatment reflects the substantial non-tax considerations that affect how an individual disposes of his or her estate. Moreover, after the death of the grantor, all trusts created by the grantor would be taxed in the same manner as the grantor's estate; as a result, the proposal would not affect an individual's decision whether to use a trust to avoid probate.

REVISE INCOME TAXATION OF ESTATES

General Explanation

Chapter 3.15

Current Law

Under present law, a decedent's estate is recognized as a separate taxable entity for Federal income tax purposes. The separate existence of the estate begins with the death of the decedent, and the estate computes its income without regard to the decedent's taxable income for the period prior to the decedent's death. Because the estate's separate existence begins with the decedent's death, the estate is entitled to adopt its own taxable year without regard to the taxable year of the decedent or the taxable year of any beneficiary of the estate. Furthermore, any trust created by the decedent's will is entitled to select its own taxable year without regard to the taxable year selected by the estate.

An estate generally computes its income in the same manner as an individual, with a $600 deduction allowed in lieu of the personal exemption. The amount of tax on an estate's income generally is determined in the same manner as a trust -- with a deduction allowed for distributions not in excess of distributable net income ("DNI") -- except that the throwback rules applicable to trusts do not apply to estates. Thus, an estate can accumulate taxable income using its separate graduated rate structure and distribute the income in a later year free of any additional tax liability.

Under present law, the decedent's final return includes all items properly includable by the decedent in income for the period ending with the date of his death. The tax paid with this return is generally deductible as a claim against the estate for Federal estate tax purposes. For Federal income tax purposes, all income received or accrued after the date of death is taxed to the estate rather than the decedent. The decedent's surviving spouse may elect, however, to file a joint Federal income tax return for the taxable year in which the decedent's death occurs.

Reasons for Change

The availability to an estate of a taxable year other than the calendar year creates tax avoidance opportunities. By appropriately timing distributions to beneficiaries of the estate, tax on income generated in the estate may be deferred for a full year. This deferral potential is exacerbated through the use of different fiscal years by testamentary trusts. Estates can also use "trapping distributions" to allocate estate income among the maximum number of taxpayers and thereby minimize the aggregate tax burden imposed on estate income.

The current rules for taxation of income during the taxable year in which the decedent dies create additional distortions. There is no necessary correlation between the timing of items of income and deduction and the date of death. Thus, for example, deductible expenses incurred prior to the date of death are not matched against income received after the date of death. This can result in the wasting of deductions on the decedent's final return or the stacking of income in the decedent's estate.

Proposal

The rules governing the taxation of estates would be changed so that the decedent's final taxable year would continue through the end of the taxable year in which his death occurs. Distributions by the decedent's personal representative to beneficiaries of the decedent's estate would not give rise to a distribution deduction against the decedent's income. As under current law, income tax accrued through the date of the decedent's death would be deductible for Federal estate tax purposes.

The first taxable year of the estate as a separate entity would be the first taxable year beginning after the decedent's death. The estate would be subject to tax at a separate rate schedule, with no zero bracket amount and no personal exemption (or deduction in lieu of a personal exemption), but with a deduction for distributions to beneficiaries. Although the estate would not be entitled to any personal exemption, an estate having gross income of less than $600 would be exempt from Federal income tax liability and would not be required to file a return (as under present law).

An estate would compute its taxable income in the same manner as any trust following the death of the grantor. Thus, the estate would be entitled to a deduction for distributions that carry out DNI, and such distributions would be taxable to the beneficiaries. For this purpose, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. As under present law, distributions that are made in satisfaction of a bequest or gift of specific property or a specific sum of money would not carry out DNI.

Effective Date

The proposal would apply to estates of decedents dying on or after January 1, 1986.

Analysis

By placing estates on the same taxable year as the decedent, the proposal would eliminate the selection of a taxable year for an estate that defers the taxation of the estate's income. Continuing the decedent's final taxable year through the last day of the year in which the decedent's death occurs would simplify the Federal income tax returns of most decedents and their estates, and would also permit simpler rules for taxing inter vivos trusts created by the decedent. See Ch. 3.14. Providing the estate with a separate rate structure and a deduction for distributions would continue some income-shifting opportunities that exist under present law; however, placing all trusts created by the decedent on the same calendar year and applying a strict multiple trust rule would limit the use of trapping distributions to shift income from estates to trusts.