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ARTICLES

REFLECTIONS ON THE TAX REFORM ACT OF 1976†

STANLEY S. SURREY*

THE TAX REFORM ACT OF 1976 is a many-faceted piece of legislation that is unique in the annals of recent tax measures. One aspect — that of its almost sole congressional authorship and almost total absence of executive branch influence — may not be repeated again for many a session. On the other hand, another aspect — that of the first test in the revenue field of the Budget Reform Act of 1974 — is probably but the forerunner of a lengthening influence on revenue measures of the new congressional budget process. Still another aspect — that of the first revenue measure to be conducted openly throughout its House, Senate, and Conference Committee mark-up sessions — will presumably be followed in the future, though no one can say with assurance how well the openness worked, what went on in preliminary closed informal meetings, or what changes would be desirable. Then there is the title of the measure itself — the *Tax Reform Act of 1976* — which raises the intriguing and not easy to answer question of just who wanted tax reform in 1976 and why did it come about. For, with all its weaknesses, the Act lies on the reform side of the tax spectrum. In this regard it is in marked contrast to the last major measure, the Revenue Act of 1971, which was the worst piece of tax legislation in modern history and one — here cause became effect — which largely reflected the then administration's views. The list of facets, whose exploration would be fascinating to the political scientist as well as the tax expert, could be continued. Thus, for example, the Act offers a wonderful political study in how the destiny of a few thousand farm families shaped a wide revision of the estate and gift taxes and the capital gains tax, revisions that will be continued in the years ahead.

Hence, before we consider the substantive provisions of this Act, it is worth spending time on the legislative process that produced those provisions.

I. THE LEGISLATIVE PROCESS BEHIND THE ACT

A way to consider the process behind the Act is to ask the question, Why a tax reform measure at all?¹ One part of the answer lies in the feeling of many Democratic Members, particularly in the House and among the newer Members, that the public desired "tax reform." While

† This Article was the basis for a Cleveland-Marshall Fund Lecture delivered by Professor Surrey at the Cleveland State University College of Law on February 3, 1977.

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¹ For a fuller description of the tax legislative process, see Surrey, *The Federal Tax Legislative Process*, 31 REC. A.B. CITY N.Y. 515 (1976).

the phrase "tax reform" has many meanings, the uppermost connotation in their minds was apparently tax fairness — elimination of escape from tax by those, especially in upper brackets, whom the public perceived, and rightly, as not carrying their share of the load. Another connotation was "simplification," itself a complex goal but still a goal. The House Ways and Means Committee had commenced tax reform hearings in 1973 but by 1974 had only produced a tentative bill which did not get beyond the Committee. Representative Ullman, who came to the chairmanship in 1975, was elected to that post after promising tax reform to the Democratic Members. At the same time, the complexion of the Committee was changed. Its membership had been increased from 15 Democrats and 10 Republicans to 25 Democrats and 12 Republicans. A number of new Members were definitely on the "tax reform" side, but unversed in tax matters — indeed 20 out of the 37 Members were new to the Committee. The reform thrust was first evident in the Tax Reduction Act of 1975, which in April 1975 produced a tax reduction prompted by the need for fiscal stimulus, that was more favorable to the lower end of the income scale than the administration desired, and also reduced the benefits of percentage depletion and some foreign income escapes. The unfamiliarity of the Committee with tax matters was evident in the fiasco of the 1975 Energy Tax Bill, in which the Committee, reworking a 1974 Committee measure, attempted to solve energy problems through tax answers before a public or legislative consensus had been reached on energy issues. The bill was rewritten on the House floor and essentially dropped.²

But the new Committee was settling down to its work and began the task of shaping a tax reform bill.³ While some Members had been over the ground in 1973 and 1974, the new Members, especially those on the reform side, had not, and considerable education was needed. The administration was not of much help or influence. It really had no desire for tax reform in the traditional sense of ending inequities but was only interested in "capital formation" and encouragement to investment, where its recommendations would have led to new unfairnesses. Guidance instead came from the Staff of the Joint Committee. This guidance, however, was necessarily cautious and sometimes veiled as the Staff struggled with the dilemma on the one side of revealing the real facts of tax life — here read "abuses" — and proposing effective solutions, and on the other side maintaining a non-partisan even-handed approach that would keep the confidence of the conservative Members and also not panic the lobbyists that thronged the Committee room. Guidance pointing to the needed reforms came from a few staff assistants specially employed, and from the Nader Tax Research Group led by Robert Brandon and assisted by Taxation With Representation, another "public interest" group, and often by the AFL-CIO. The Members

² For the initial history of the energy bill, see Morrison, *Energy Tax Legislation: The Failure of the 93d Congress*, 12 HARV. J. LEGIS. 369 (1975).

³ Those interested in following a detailed account of the bill's progress through the Congress should consult TAX NOTES, an informed weekly publication of Tax Analysts and Advocates, which also provides the voting records in Committees and on the floor.

who were resisting reform needed little staff guidance for there were plenty of private interest lobbyists available on each issue to supply them with data, positions, and debating points.⁴

The struggle between these two groups shaped the House bill which passed in December 1975. The Committee was almost evenly divided on many issues and a few swing votes — the focus of lobbying — often determined the compromises and the outcome. The bill that emerged on the whole definitely carried a reform aura and overall achieved \$1.2 billion of reform for fiscal year 1977.⁵ While not by any means the strongest of measures, on a number of matters it moved the dividing lines in a reform direction. Moreover, it did not open serious new weaknesses.

On the Senate side, however, it was all downhill. The Finance Committee reshuffled the House approach to many of the critical areas and this reshuffling usually meant reduced reform. At the same time, new tax concessions appeared, such as a downward sliding scale for capital gains, and a reduction in the maximum 70 percent rate on \$100,000 of investment income (if the individual also had that much earned income) to 50 percent. A multitude of specially tailored provisions were packed into the bill. The Committee moved rapidly (because of a promise by Chairman Long to the Senate Democratic Policy Committee, which wanted some reform action, to produce a bill), was not as conversant with the issues or details as the House Committee, kept the Joint Committee Staff on a tight rein, and was dominated by its non-reform majority.

The bill was then considerably reshaped on the Senate floor during June-August 1976, sometimes for the better but often for the worse. Chairman Long in defending the bill faced two lines of attack. One line was pressed by a tax reform group better informed and more ably led than the Senate had seen before. The center of this activity was Senator Kennedy, who with Carey Parker of his staff and the aid of Professor Paul McDaniel of Boston College Law School as a special assistant, coordinated a steady drumfire against the bill.⁶ While the group met defeat — often by only a few votes — on most of its efforts to strengthen the reform provisions, it did score a success here and there (*e.g.*, the “at risk” partnership provision), and did remove some of the weaknesses inserted by the Finance Committee (*e.g.*, the two mentioned above). It also spotlighted, with the aid of the Nader Tax Research Group, the many special provisions in the bill and forced their recon-

⁴ The “openness” of Committee sessions did in this regard pose a problem for the deliberations. As the Committee discussions and votes proceeded, lobbyists would pass notes to the Members or call them outside for conferences. A number of Members resented these interventions, and the process indeed at times seemed to resemble football coaches calling each play and move. Clearly, the Committee will have to devise mechanisms to handle this situation. It may be noted that the Conference Committee, apparently as a result of the House Committee experience, did not allow these activities.

⁵ Later estimated as \$1.4, \$1.6, and \$1.7 billion on changing assumptions about enactment dates and revenue levels.

⁶ Illustrative of the preparation was a pamphlet, prepared at the request of these Senators, edited by Stanley S. Surrey and Joseph Pechman, containing analyses on the principal issues contributed by various experts: 122 CONG. REC. S. 11591-627 (daily ed. Jul. 2, 1976). The pamphlet was later published as *FUND FOR PUBLIC POLICY RESEARCH, FEDERAL TAX REFORM FOR 1976* (S. Surrey, P. McDaniel & J. Pechman eds. 1976).

sideration by the Finance Committee, with some resulting cutback. A crucial aspect of the contribution of this Senate group was the opportunity and insight it gave the press to focus on the weaknesses of the Senate bill considered as a reform measure, a focus that was to put the sponsors of the bill clearly on the defensive when the measure went to Conference with the House.

The second line of attack was led by Senator Muskie as Chairman of the Senate Budget Committee. That Committee, with its House counterpart, had developed the First Concurrent Resolution for fiscal year 1977 specifying the revenue and spending goals for that year. This action was the first formal measure enacted pursuant to the Budget Reform Act of 1974, which prescribed both this preliminary Resolution setting the goals and a later Second Concurrent Resolution setting final levels. The First Concurrent Resolution, passed May 13, 1976 (while the tax bill was under consideration by the Senate Finance Committee), set a revenue goal of \$362.5 billion. The accompanying Budget Committee Reports indicated that this figure permitted a tax bill with a revenue loss of \$15.3 billion but went on to indicate — and this was the crux of the Budget Committees' position — that this figure represented a combination of a \$17.3 billion revenue loss with respect to overall fiscal policy, and a \$2 billion revenue increase from changes in existing "tax expenditures."⁷ In customary terminology "changes in existing tax expenditures" can be read as tax reform, and indeed the goal set by the Resolution was that of significant reforms amounting to \$2 billion. But the reference to "tax expenditures" was deliberate. Chairman Long had earlier defined "tax reform" as meaning "anything that can muster 51 votes in the Senate." However, the President's Budget (Special Analysis F) contains a list of tax expenditure items as do publications of the Budget Committees and of the Staff of the Joint Committee. These tax expenditure items — special tax provisions providing tax preferences for certain industries, groups, or activities — total over \$100 billion of spending programs — in the form of tax reductions — run through the tax system. They constitute the issues that compose the battleground of tax reform in the Congress. Hence, under the Budget Committees' action the Congress was being given the goal of achieving tax reform through cutting an existing specific list of preferences by \$2 billion.⁸

The Budget Resolution reform goal was precise, but it was obviously not Chairman Long's view of tax reform. Nor did Chairman Long accept the division of the \$15.3 billion revenue loss limitation into the two components of minus \$17.3 billion of the fiscal tax reduction and plus \$2 billion of reform. He did accept, however, the \$15.3 billion overall limitation, and in the Finance Committee had struggled to stay under that limitation by various devices such as using early effective dates for reve-

⁷ Those interested in exploring the tax expenditure concept and its interrelationship with the Budget Reform Act are directed to Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976).

⁸ The 1975 Budget Resolution, a test run of the new congressional budget process, had called for \$1 billion in tax reform.

nue raising "reforms" but postponed dates for revenue losing "reforms," shorter extensions of the 1975 tax reductions, and rejection of some revenue-losing measures pressed on the Committee. The bill did essentially meet the \$15.3 billion limitation, but because of the arranged effective dates only showed about \$1 billion of tax reform for fiscal 1977 and then losses from new or expanded tax preferences that actually exceeded gains in tax reform for subsequent fiscal years.

As a consequence, Senator Muskie challenged the Finance Committee bill by insisting that the reform component of the revenue goal should be met. Unfortunately, the components of that goal were set forth in the Budget Committees' Report and not in the Resolution itself, though a fair reading of the Budget Reform Act and its legislative history clearly supported Senator Muskie. However, Senator Long in debate was able to focus on the single \$15.3 billion target in the Resolution. The clash was direct, though the debate generally skirted the real stakes. In essence, the Finance Committee was challenging the view embodied in the Budget Reform Act that the tax system was made up of two parts, the structural provisions involved in imposing income and other taxes and the spending provisions embodied in the numerous tax expenditures. Given that view of the tax system and given the authority of the Budget Committees to say that the overall spending goal and the subject matter breakdowns for the budget functions falling within the jurisdiction of the various substantive Committees (including Finance on its direct spending jurisdiction, *e.g.*, welfare) involved certain assumptions as to particular spending programs, Senator Muskie was on sound ground. But the tax expenditure approach to the tax system was new, albeit essential to the functioning of the Budget Reform Act (how set a ceiling for "education" spending that confined the Education Committees if the Tax Committees were free to enact tax credits for education?). Of course the Senate could always overrule the Budget Committee and decide to depart from the assumptions and components leading to the overall goals in the Resolution. But the departure would be seen as a departure from the Budget Resolution targets and something else would have to give, such as other components or the goals themselves. Senator Long did not want to concede that his focus on the overall \$15.3 billion target and his disregard of the components was a departure from the Budget Resolution targets. Senator Muskie, on the other hand, was insisting that the Finance Committee bill was indeed a basic departure from that Resolution.

Thus was produced the clash between two powerful Senate Chairmen. Senator Muskie on close votes lost two initial tests formulated almost as semi-procedural motions. While the result was not fully conclusive, both opponents decided not to press thereafter for a definitive show-down. The lengthy debate on the bill then proceeded against the background of Senator Long's view, with Senator Muskie and the tax reform group (in which Senator Muskie was not a direct participant) pointing out from time to time that the \$2 billion reform target was not being met. Indeed that target was lost from sight as Senator after Senator pushed revenue-losing measures including expensive new tax

expenditures, such as a tax credit for education. Since the Senate has no limit on amendments or on germaneness and all 100 Senators are free to play in the amendment game, this amendment-loading process is almost a Senate ritual. In part it was this ritual which Senator Muskie sought to stop by pressing his concept of the Budget Reform Act.

The final Senate bill showed a "reform loss" of \$262 million for fiscal 1977 and greater losses in subsequent years. The bill also showed an overall loss of \$17.6 billion for fiscal 1977. But two events had cast a shadow on that bill. Senator Long himself at the end of the debate inserted an amendment that it was the sense of the Senate that the Senate Members of the Conference Committee seek to reduce the revenue loss of the bill to the \$15.3 billion goal. And the strong stand made by Senator Muskie emphasized, for the Congress and the press, that the absence of significant tax reform — indeed a tax reform loss — was directly contrary to the First Concurrent Resolution and the entire thrust of the Budget Committees' goals as well as a threat to the new budget process itself. Thus while both lines of attack on the bill — by proponents of direct substantive reform and by supporters of the budget process — were turned back in the Senate debate, the attackers had succeeded in spotlighting the issues faced by the Conference Committee as it took over the task of reconciling the House and Senate versions.

In the Conference Committee the strong attacks in the Senate made their mark. The battle temporarily lost on the Senate floor was won in the Conference, as the pendulum swung back to the overall revenue outlines of the House bill. Indeed, the process in the House and Senate forced both chairmen to seek a significant tax reform total. Chairman Ullman and the House conferees desired to demonstrate they were strong "bargainers" and were pressed by the tax reformers on the Ways and Means Committee. Chairman Long wanted to show he could control his side of the process and not have the free-wheeling Senate debate distort his bill. Also he could not depart too far from the budget process, and indeed there was his own amendment seeking a revenue loss limitation of \$15.3 billion. Given that limitation, the arithmetic of the bill necessarily pointed to significant tax reform. The fiscal policy tax reductions — the extension of the 1975 tax cuts — were necessary both as a fiscal step and a tax policy step since Congress did not want to *increase* 1976 income taxes over 1975. But these reductions came to somewhat over \$17 billion. Hence the Conference could not get from this \$17 billion tax reduction loss to the limitation of \$15.3 billion without significant tax reform. (Did Chairman Long recognize this all along as the bill proceeded in the Senate and as *he* added the \$15.3 billion amendment at the close of debate. The Senator is a very intelligent man with an acute sense of tactics and an awareness of when one is nearing a precipice. He also had certain substantive goals of his own — ESOPs for one — which he accomplished in the Conference.) Both chairmen also knew the press, the public, and their colleagues thought that a bill labelled "tax reform" had to contain some tax reform, and the \$2 billion figure had been mentioned time after time. They also recognized that

the new budget process had received both strong support and well-earned acclaim as permitting Congress to put its budget-making and fiscal policy processes under control for the first time. Hence, a departure in this tax bill from the repeatedly stressed "tax reform" goal of the Budget Committees would be a marked exception.

These and probably other factors that mortals outside the Congress and the minds of its Members can never perceive shaped the Conference Committee bill and thus the final Act. It emerged with an overall revenue loss of \$15.7 billion and a plus of \$1.6 billion in tax reform. Moreover, the estimates for that tax reform plus increase steadily for future fiscal years.⁹ Clearly the Conference measure in its overall reform posture followed the House bill and not the Senate bill. In this sense, and always keeping the words "tax reform" in a realistic perspective, the tax reformers won the battle over the 1976 Act. The significance of this victory is underscored by the fact that the bill was a congressional bill throughout, with provisions largely shaped by the Joint Committee Staff. There was no push from the executive branch for tax reform, indeed usually only obstacles, disinterest, or incompetence, depending on the particular issue. Intriguing questions thus emerge from this "process" of the 1976 Act: Is there even stronger support for "tax reform" in the Congress if the measures are pushed, the provisions carefully formulated, and the debating points strongly argued by the Executive? If so, what does "tax reform" in this context cover?

II. THE SUBSTANTIVE PROVISIONS

A. *Income Tax*

Let us turn from the process behind the 1976 Act to the substantive aspects of that Act. Necessarily we can see only the highlights. The text of the Act covers 414 pages, the three committee reports total 1,367 pages, the floor debates stretch over months, the hearings take many volumes, the Joint Committee Staff General Explanation covers 682 pages. Moreover, the words and pages of tax institutes on the Act overwhelm the tax bar, and there are still the regulations and articles to come. Acts such as the 1976 Act are never sought in the prayers of practitioners, and for them some serenity in daily practice can come only if tax reformers are cast into outer darkness. The Act means that well-understood tax planning must be discarded or altered; many new rules puzzled through with their danger points, both marked and hidden, sought out; new plans devised to satisfy clients ever-seeking tax minimization or even only safety. And where are the bright associates to face these grinding tasks while the seniors despair at learning still another new Act and wonder about retirement?¹⁰

⁹ For a detailed description of the tax expenditure changes made by the 1976 Act, see CONGRESSIONAL BUDGET OFFICE, FIVE YEAR PROJECTION OF TAX EXPENDITURES (1977).

¹⁰ The main fields omitted in this review are: *Administrative Provisions* — Here the principal items, which seem on a quick glance to be sensibly dealt with, are inspection of returns, disclosure of return information including private rulings, jeopardy assessments, and income tax return preparers. Withholding on interest and dividends was hurriedly

1. *The Upper Brackets — Tax Shelters and Capital Gains*

a. *Tax Shelters*

Tax reform for some time has focused on the escapes from tax of upper bracket individuals with large cash flow but little or no tax payments. The Kennedy-Johnson Administrations had stressed this situation, with examples and data describing the paths to tax escape. The Nixon-Ford Administrations turned off this flow of information and showed almost no interest in the subject. But the Congress was slowly learning about one major escape path, that of tax shelters.¹¹ The House Ways and Means Committee in its 1973 and 1975 hearings heard from invited practicing lawyers just how tax shelters were constructed and the comfort they could provide. But as knowledge about tax shelters increased, the reform solutions became more difficult. [Tax shelters are] built on deferral of tax. Indeed, the Revenue Act of 1976 really marks the point when recognition of the advantages of deferral of tax commenced to be understood by some of the legislators.¹² The deferral for tax shelters is principally produced through the use of current or rapid tax write-offs for capital items, such as accelerated tax depreciation and expensing of construction interest and taxes (real estate); intangible drilling expenses (oil); expensing of feed and other items involved in growing cattle, crops, or orchards (farming); accelerated

pushed forward in the Senate for its revenue-raising potential, but because the ground had not been prepared it was quickly defeated. Such withholding, however, merits proper consideration.

Capital Formation — Here the major gain was in avoiding major damage. The principal items adopted were extension of the 10 percent investment credit, and a five-year 1 percent ESOP credit. ESOP remains in serious need of careful study. It is doubtful it would survive without Senator Long's strong support, but the image of employee stock ownership that it carries requires a broader analysis of that matter.

Extensions of 1975 Income Tax Reductions — Here the Congress has, as a result of various maneuvers and pressures, produced a complicated set of provisions to keep the starting level of the individual income tax around the poverty level. We now have personal exemptions, a low income allowance, and per capita credits against tax as the ingredients to achieve this goal. Then there is the cross-cutting earned income credit, whose purpose and potential are cloudy. The 1976 reductions in the corporate normal tax were continued for a year.

Tax Exempt Organizations — Here the main changes are a complicated structure to allow lobbying by tax-exempt organizations, a move of doubtful wisdom and clearly wrong in its allowance for grassroots lobbying, and a method for declaratory judgments to review denial of tax-exempt status but with no provision — Why? — permitting public interest review of the grant of such status.

Other Areas — There are many other items of acute interest and importance to those who are involved in the specializations affected — e.g., pension trusts, railroads, airlines, real estate investment trusts, Subchapter S, accumulation and multiple trusts, and a host of miscellaneous provisions, each vital to the narrow interest involved.

¹¹ Learning of this kind generally comes late to the Congress. Tax practitioners are prone to forget that the Members, even those on the tax committees, are not experts, so that what passes as everyday know-how at tax club lunches is strange and confusing to the Congress. There is even a lag in Joint Staff knowledge and often Treasury knowledge. As one example, the tax reformers in the Senate had to patiently explain to their colleagues that generally only 50 percent bracket or above persons inhabited these tax shelters and not their middle-America constituents.

¹² See — as an example perhaps of at least Staff recognition — the Committee Report comments regarding the elimination of section 1251, which stress the ineffectiveness of recapture as an anti-shelter strategy because of the deferral which recapture permits.

depreciation and the investment credit (leasing); current expensing of production costs or rapid amortization of purchase price (motion pictures, books, records); depreciation (sports franchises); expensing of syndication and organization fees, and special partnership allocations of losses (all types); and the various five-year amortization provisions. But for the principal activities — real estate, farming, oil — the write-offs were a product of intended congressional assistance to those directly engaged in the activity.

Hence for most Members the desired solutions would not cover such persons but would hit the tax shelter seekers — the Wall Street cowboys, the doctors who bought into housing syndicates, the investment bankers who became oil drillers. As the tax bill was taking shape in the House, direct solutions were thus off limits. The indirect solution, favored in the House and also advanced by the Treasury, was LAL — a limitation on the use of tax shelter losses only against income of the kind sought to be protected by Congress — real estate income, oil income, farm income — so that the losses could not shelter professional income, investment income, salaries and the like. The LAL solution left the activity tax exempt since, for example, real estate tax losses could eliminate rental gross income, but would make the investor-doctor's fees taxable. The LAL solution had power behind it, given the target selected, and hence the lobbying against it was strong.¹³ As a result, when the House bill with the LAL provisions reached the Senate, LAL was no longer a viable solution because of that lobbying.

The Senate turned to a new solution, which had been partially introduced in the House bill. This was the "at risk" approach. Many shelters are constructed with debt leverage through funds borrowed from various lending institutions willing to limit the security for the loan to the tax shelter asset and thus not to require any personal liability on the part of the tax shelter investor. The leverage multiplied the tax magic of the rapid write-offs, and permitted the small equity investment of the participants to be quickly returned. The only "danger" run by the investor using debt leverage was an early collapse of the shelter, which could bring the recapture provision into operation, thus requiring him to pay the taxes that he would have been paying under proper tax rates. The "at risk" solution was designed to eliminate leverage as a factor and thus make unattractive those shelters sold on a leverage basis. It permitted tax shelter losses to be allowed, against any income, only to the extent of funds really risked by the investor. Once such personal liability was required on the part of shelter investors, many would focus on the real risks involved in their participation and would decide against the investment. The Finance Committee did not extend the "at risk" solution to real estate, but a successful maverick proposal of the tax reform group on the Senate floor applied the "at risk" limitation to limited partnerships.¹⁴ The "at risk" approach is still an indirect solution, for it un-

¹³ The real estate interests succeeded on the House floor in keeping LAL applied on an overall basis to real estate rather than the far more effective approach of parcel by parcel.

¹⁴ The amendment caught the real estate interests by surprise and dazed them. But

derscores the fact that the rapid depreciation and current expensing involved in tax shelters are at variance with the real world. Clearly, those institutions lending on the security of tax shelter asserts do not see those assets decaying at the rapid rate underlying the tax loss computations. Both the House and Senate bills did contain direct solutions limiting the manipulations of the partnership form of operation — such as retroactive loss allocations to a new partner — that were frequent in tax shelter operations.

At the conference stage it was clear that tax shelters would have to bear a share of the revenue reform total. The House gave up its LAL approach which already had been vitiated by strong lobbying, and agreed to the “at risk” approach both for particular shelters and limited partnerships in general (except real estate). The oil shelters, many of which are not leveraged, gained on this exchange (though recapture did finally come to intangible drilling expenses), whereas most of the other shelters, harder hit, came out about the same. The problem was real estate, which wanted neither LAL nor even the milder “at risk” Senate floor amendment. Yet it was clear to the conferees that the real estate shelter had to make its contribution to tax reform. So on the last day, without warning and hence without opportunity for industry attack, the conference adopted a new and direct approach, that of capitalization of construction period interest and taxes, with a 10-year write-off. The transition to the new rule is slow, especially for residential real estate, but the rule is there. It is a direct, rational attack on the deferral allowed by the prior permission to expense these capital items.¹⁵

What then is the verdict on the tax shelter rules of the 1976 Act? Clearly some shelter activity of individuals seems to be badly hit — farming, motion pictures, equipment leasing, some oil activity. But real estate seems to have survived in reasonably good shape, though even here new obstacles and uncertainties will have to be sorted out by the developers, syndicators, and investors.¹⁶ The final results in all shelter

a number of Senators voted for it on the simple ground that deductions ought to be allowed only when one's own funds are at stake — a common-sense concept but appalling to sophisticated syndicators of tax shelters. This is another illustration of the gap between the Senate floor and the complex everyday tax world.

¹⁵ Motion pictures, books, and records were made subject in the Senate to a capitalization requirement of the costs of production, with amortization over the income stream, and the Conference accepted this approach. The motion picture shelter, however, was clearly fair game for Members desirous of jumping hard on at least one tax shelter.

The limitation on the deduction of interest on investment indebtedness was strengthened in the Act by reducing the limit from \$25,000 to \$10,000 (plus investment income) with no offset of such interest allowed against long term capital gain. This change was a reflection of the House bill, which, however, had gone further and placed a limit of \$12,000 on mortgage interest.

¹⁶ Thus, the strengthened minimum and maximum tax provisions hitting at the accelerated depreciation preference; the carry-over basis at death rule which can subject heirs to the unpleasantness of the “turn-around” in the shelter (the basis step-up at death had previously shielded them); perhaps the strengthened limitation on the interest deduction, will all play a role depending on particular circumstances. Moreover, for commercial real estate and high-rise residential construction, the new construction interest rules can be a factor, more so than in garden-type residential construction which is built in small sections and hence carries less construction interest. Also, real estate investors may have to accept lower rates of return since the developers move into better

areas must await the searching inquiry now underway by those who apply their ingenuity to shelter activity. But one conclusion is clear. Obviously, much more is required on the legislative side before tax shelters are conquered. Thus, corporations are not covered by the new rules, except for the accrual accounting required for large farm corporations. And, as indicated above, many real estate and oil shelters for individuals will survive.¹⁷

The crucial question is whether the Congress has learned the real lesson in this tax shelter part of the 1976 Act. This lesson is that some tax shelters survive through successful lobbying because assistance may really be required if the activity involved is to be undertaken. The best illustration is subsidized low-income rental housing where the direct subsidies are inadequate to sustain the activity and the tax shelter must provide the developer with his compensation, through the "sale" of the tax shelter preferences to the "doctor" investors. Thus, the real estate lobby can protect the tax shelter because a real national interest is involved. But that interest points not to the haphazard solution of the tax shelter and its unwarranted tax escapes but to a rational consideration of better direct assistance programs. Perhaps some middle-income residential rental housing also is in this category. However, up to now the executive branch has completely neglected any consideration of this basic relationship. The Congressional Budget Office sees the situation clearly and has a study under way to determine whether direct assistance can substitute for tax shelters. Nor is this approach limited to real estate. If any tax shelter is defended on grounds of a national interest — *e.g.*, oil exploration — the right approach is a coordinated study to see if such a national interest is really involved and if so whether a direct assistance approach would be a more rational solution than jerry-built tax shelters. Such an approach would then permit direct tax solutions to the tax shelter world.

b. *Capital Gains*

The Wall Street-Washington lobbyists axis worked hard in 1974 to drastically reduce the tax on capital gains. The rallying cry was "inflation" and the proposed solution a sliding scale under which the longer an asset was held, the smaller would be the amount of the gain included in income. Under this approach after 15 years only 20 percent of the gain would be included, so that a 70 percent bracket individual would be taxed at a rate of 14 percent on the total gain. Since most capital gains are enjoyed by upper bracket individuals (families above \$25,000 income account for 55 percent of all capital gains; families above \$100,000 income — 1 percent of all returns — receive about 30

bargaining positions with other types of tax shelters having been hit harder. But on the other hand there is a new opportunity — the Act gave a preference (five year amortization) to "historic structures" and thus many an historical district in our cities may find a new chapter written in their history as they become the scene for tax shelter activity.

¹⁷ For an early discussion, see Fossum & Peters, *Tax Shelters and the Tax Reform Act of 1976: Patching the Leaky Tire*, 5 TAX NOTES 7 (Jan. 17, 1977), criticizing both the complexity and incomplete efficacy of indirect approaches to the tax shelter situation.

percent of all capital gains), the proposal was of course a distortion of the income tax. Moreover, its defense on inflation grounds would not stand analysis.¹⁸ Nevertheless, the proposal was adopted in the 1974 tentative Ways and Means Committee bill. It was therefore clear that capital gains would be a controversial matter in the 1975-76 reform bill.

The effect of the addition of liberal members to the House Committee was evident in the capital gain area. The sliding scale was again an issue, this time supported on grounds of "capital shortage" and the "need for capital formation." But the Committee, by a close vote, shuffled "capital formation" issues to a special Task Force. It then tightened the rules on capital gains — extending the six months holding period to twelve months and strengthening the minimum tax by raising the 10 percent rate to 14 percent, lowering the basic exclusion for preferences to \$20,000, and eliminating the regular tax offset to the preferences subject to the tax. Since the 50 percent untaxed portion of a capital gain is quantitatively by far the most important preference covered by the minimum tax, these changes represented an increase, albeit indirect, in the tax on capital gains.

The Senate Finance Committee saw the capital gains world differently. It retained the six months holding period and adopted a sliding scale approach, which at this point was being strongly urged by the Treasury, under which 70 percent of the gain from an asset could be excluded if the asset were held for 25 years. It also retained the regular tax offset against preference items under the minimum tax, with a \$5,000 alternative if higher, but adopted a 15 percent rate. The reform group on the Senate floor was able to defeat the capital gain sliding scale by portraying its benefits to upper bracket individuals. Also, apparently, this issue was not one of Chairman Long's priorities.

In the Conference Committee, the 12 months holding period was restored. The minimum tax ended up with a 15 percent rate, and the greater of \$10,000 or one-half the regular tax as an offset to the covered preferences. Translated into an effective rate on capital gains, this meant around a 40 percent rate for an individual in the 70 percent bracket.¹⁹ At the same time, the maximum tax was altered to make the preference items (the same as those under the minimum tax) a direct offset against compensation otherwise to be favored by the 50 percent maximum rate (thus eliminating the previous \$30,000 preference exemption). Hence, a 70 percent bracket executive with a capital gain can find almost 10 more percentage points added to the effective capital gain rate, making it around 50 percent.²⁰

¹⁸ See, e.g., Brinner & Surrey, *A Tax Escape for the Few*, Washington Post, May 26, 1974, at N1; Brinner & Munnell, *Taxation of Capital Gains: Inflation and Other Problems*, NEW ENGLAND ECON. REV. 3 (Sept./Oct. 1974); R. BRINNER, *Inflation and the Definition Taxable Personal Income*, in THE BROOKINGS INSTITUTION, INFLATION AND THE INCOME TAX 121-51 (1976).

¹⁹ 70 percent of one-half the gain (the regular tax) plus 15 percent times one-half the gain minus the regular tax, or 35 percent plus 4.8 percent, or 39.8 percent. The remnant of the 25 percent alternative tax, with its maximum benefit of \$5,000 of regular tax, is of course still around.

²⁰ The preference item of one-half the capital gain eliminates pro tanto the reduction

The interesting aspect of this legislative history on capital gains is that the Congress seems unwilling to lower the present rate directly, but also unwilling to raise that rate directly. However, the minimum tax concept had a reasonably strong appeal, plus a decided revenue reform potential — \$1 billion in fiscal 1977. Thus, the indirect approach to heavier capital gains taxation through a tightened minimum tax had broad support and the deed was done in this fashion. The legislative history also showed broad support, at least in the Senate, for the 50 percent maximum tax on earned income despite attack by the reform group on the ground that the favorable rate benefited almost entirely the few individuals with earned incomes of over \$100,000. (More than one-half the \$270 million revenue loss goes to those earning over \$200,000 — about 23,000 persons according to 1972 data.) As tax rates thus stand, earned income is at a maximum rate of 50 percent and likely to stay there. Investment income is at a 70 percent rate and not likely to be reduced except as part of a broad reform package. Capital gains are at a maximum rate of about 40 percent, except for some executives and professionals where the rate is about 50 percent. If the one-half the regular tax offset is eliminated from the minimum tax, as the House voted, the capital gain rate would go to 42.5 percent.²¹ Are we therefore edging closer to the time when the capital gain preference, with all its definitional complications,²² can be eliminated as part of a package producing, say, a top overall rate around 50 percent?

When the components of the \$1.6 billion of tax reform are analyzed, clearly the revenue came from the upper brackets. The two major individual income tax components on the plus side were tax shelters (\$417 million) and the minimum and maximum tax changes (\$1.1 billion),

from 70 percent to 50 percent in the rate on a comparable amount of compensation, in effect adding to regular tax 10 percent of the capital gain. This regular tax increase then slightly reduces the minimum tax on the gain to 4.1 percent, giving a total capital gain effective rate of 35 percent plus 10 percent plus 4.1 percent, or 49.1 percent.

The Conference Committee, following the House, did extend the allowance of capital losses from \$1,000 to \$3,000 of ordinary income.

Stock options, already badly battered by attacks in 1964 and 1969, finally lost their capital gain status. It thus has taken 26 years to repair the legislative mistake of 1950, when the court decisions were statutorily overruled and stock options given their "honorary" capital gain degree. Tax reformers must indeed be patient folk. But also aggressive — for their constant attacks on the stock option preference gradually destroyed the defense of that preference.

The new stock option status is clouded, however, by fuzzy language in the Conference Committee Report that the grant of a stock option is to be currently valued if this is feasible and hence taxed as ordinary income, thereby giving the future appreciation a capital gain status.

²¹ Regular tax of 50 percent of half the gain plus minimum tax of 15 percent of half the gain.

²² There would have to be a limit on the allowance of losses on securities against other income, since otherwise a taxpayer, by realizing such losses and postponing his security gains, would have too great an advantage. It may be sufficient only to allow losses on securities against gains on securities, with a carryforward. (A taxpayer can usually control the timing of losses on securities but not on real estate; section 1231 already allows its covered losses against ordinary income.) A taxpayer could be given the option of electing a "constructive sale" on appreciated securities if he wanted immediate full use of realized losses or there may be other alternatives that should be considered to meet this problem.

and these are upper bracket preferences.²³ The other major items were DISC in the corporate area (\$468 million); elimination of the sick pay exclusion (\$380 million), largely a middle income and above item; and disallowance of deductions for vacation homes and business use of homes (\$207 million), probably largely an upper bracket item. Thus, the major individual revenue raising reforms in the 1976 Act were aimed at upper bracket escapes from tax.

But the tightening was only along a few lines. The tax-exempt state and local bond interest area was untouched, though an optional taxable bond subsidy was reported by the House Committee.²⁴ Pollution-control exempt bonds were untouched, though their tax escapes and burden on municipal financing have been fully documented. Percentage depletion was untouched. Real estate shelters, as stated above, were only somewhat bruised. The benefits to the upper brackets of deductions for personal consumption expenses, especially mortgage and consumer interest and taxes, were untouched. There obviously is considerable room for further reform if the upper bracket tax escapes are to be ended.

2. *Individual Deductions*

We may hasten over the potpourri of changes in the individual deductions. The Joint Committee staff grouped some of these under the title "Tax Simplification of the Individual Income Tax," largely so that the Congress could point to the title since the changes thereunder are few indeed and "simplification" is not a word to be used in describing the 1976 Act. The principal items are the retirement credit, a real simplification that cost \$400 million to achieve, and the change of the child care deduction to a credit, also at a cost of about \$400 million and not much of a simplification but a fairer use of this tax expenditure revenue. Backward steps were taken in the new deduction for group prepaid legal services and the loosening of the charitable deduction for charitable contributions of certain inventory items. There were also the several major changes earlier mentioned, tightening the sick pay rule and the rules in the business-personal category as to vacation homes, business use of residences, and foreign conventions.²⁵

²³ The overall change in the capital gain area was somewhat on the plus side, with the revenue gain from the 12 months holding period outweighing the revenue decrease from the increased loss allowance.

²⁴ The 1976 Act does permit the formation of mutual funds investing in tax-exempt securities, and such funds are now being formed and widely advertised. Both as a substantive matter and from the standpoint of achieving developments in this field, it would have been wiser to postpone consideration of the mutual fund change until the taxable bond option was taken up.

²⁵ The foreign convention rule is indeed awesome. The rule allows deductions for two conventions a year (itself an arbitrary line) and is hemmed in with a huge apparatus of detailed requirements and paper work to support those deductions. It seems that the Conference Committee knew what the correct limitation was — that in the Senate bill of allowing deductions only when it was clearly appropriate that the convention have a foreign site — but could not adopt that rule for reasons of legislative commitments and a confusing parliamentary situation. It almost seems that the Committee then deliberately adopted

All in all, the area of personal deductions was passed over. It remains, as we shall indicate below, the crucial key to whether some degree of "simplification" can be achieved.

3. *Foreign Income*

The 1976 Act contains numerous provisions relating to the treatment of foreign income and this area can be considered a major aspect of that Act. The changes — outside of DISC — represent a tightening of the preferences on the fringes, with little revenue impact — \$150 million revenue gain. But the two major targets of the reform group, targets that at the initial consideration of the Act seemed well within reach, escaped with minimum damage. These targets were elimination of deferral of tax on foreign controlled subsidiaries and of DISC. Deferral escaped entirely. DISC, considered earlier as clearly vulnerable, was cut back by somewhat under one-third. Both targets survived because of several factors: A tremendous, well-organized business lobby to defend DISC that dragged in local employee groups by pressing the cry of "jobs lost" if DISC fell, though the AFL-CIO itself knew the cry was false and supported the reform attack on DISC; a resort to the "small business" slogan by urging that small business was just beginning to understand and benefit from DISC; a strong business defense of deferral that drew on the DISC lobby; and a Treasury Department defense of both deferral and DISC.

The Treasury defense of DISC was a shameful use of data by top policy officials that clearly embarrassed the technicians who knew better. Its defense of deferral was likewise ill-argued. The business defense of DISC — though emotionally pitched on "jobs"²⁶ — was understandable on pure money terms. The major corporate organizers of the lobby were the principal beneficiaries of the DISC tax reduction. Some legislative moves are indeed simple to understand! The seemingly broad business defense of deferral is less clear. Many major companies do not gain from deferral because their foreign tax rates are high, and the benefits would thus seem to be selectively distributed. The revenue involved — if the Treasury is correct — is around \$365 million, not a large sum compared with the \$1.5 billion that DISC carried. Perhaps the revenue loss from deferral is understated; perhaps it is recognized that if deferral falls there is no possible intellectual defense for DISC; perhaps the defense for deferral is tied to the development of the section 861 regulations which involve considerably more revenue than deferral. Or is it that business sees the attack on deferral as a prelude to an attack on the foreign tax credit, which clearly transcends in importance

the silly enforcement apparatus so as to ensure a future legislative re-examination of the matter.

²⁶ The "jobs" defense made no economic sense. It is not the task of micro-economic tax changes such as DISC or tax shelters to provide jobs. That responsibility rests on macro-economic policies. It is thus a useless — and empirically impossible — debate to determine if DISC or deferral results in a gain or loss of jobs. If the debate must be waged, however, the opponents of these preferences can hold their own as to the effect on jobs.

to business all other foreign items? Yet the Senate tax reform group led by Senator Kennedy carefully did not attack the foreign tax credit.²⁷ Indeed that group developed a rational technical approach to the elimination of deferral that took account of business problems.²⁹

Clearly deferral is on weak ground, at least in the Senate where it hung by one or two votes.²⁹ DISC also is on weak ground, with most Congressmen knowing the real weaknesses of that provision, but affected by the concentrated lobbying. Such concentrated lobbying cannot always be mounted. And a wiser Treasury could state the issues and debating points with more perspective and enlightenment.

As to the fringe items, the principal among these were a cutback of the section 911 exclusion for individual foreign earned income, a cutback that was relatively severe and over complex, so that it would be a rational step to end the exclusion entirely; a tightening of the foreign tax credit rules to eliminate the per-country limitation so that only the overall limitation remains, to provide for recapture of losses applied against United States income before credits are fully allowed when a foreign activity then turns profitable, and to reduce the impact on the credit of the capital gains preference; a removal of the less-developed country preferences by requiring complete gross-up in applying the foreign tax credit and eliminating the exceptions to the section 1248 tax; a tightening of the rules on foreign trusts. Ground was lost, however, in the treatment accorded to operations in Puerto Rico, whereby exempt income is now allowed to be currently repatriated to a United States parent from a Puerto Rican subsidiary, whereas before there was at least the barrier of a liquidation.³⁰

The foreign income area which has been a focus of reform over the years and which in each act receives some corrective steps — except for the folly of DISC in the 1971 Act — thus awaits the decisive action of the elimination of deferral. Such elimination, if carried out in proper technical fashion, would permit a cleaner and simpler treatment of

²⁷ See FEDERAL TAX REFORM FOR 1976, *supra* note 6, at 77-92.

²⁸ For example it allowed consolidation of foreign income and losses — the absence of such consolidation would have meant a further revenue gain of around \$750 million.

²⁹ The denial of deferral as an attack on foreign bribes is an illustration of how deferral is regarded. All devices — denial of deferral, foreign tax credit, and DISC — were utilized in the tax approach attack on United States companies participating in the Arab countries' boycott. 1976 Senate consideration also saw the entry of new elements in the tax legislative process, *i.e.*, a study by the Library of Congress Congressional Research Service on DISC and strong effort by Senator Church's Subcommittee on Multinational Corporations to eliminate deferral.

The recent GATT panel of experts decision holding DISC an export subsidy because of its deferral of tax on export income also held that foreign tax systems adopting a territorial approach excluding income from foreign permanent establishments or dividends from foreign subsidiaries likewise involved export subsidies where foreign sales were involved. The reasoning of the panel leads to the conclusion that deferral of tax on foreign subsidiaries (and a fortiori an exemption approach) is contrary to an appropriate international tax norm for the treatment of foreign income.

³⁰ The Act made permanent the exemption for interest paid to foreigners on bank deposits in the United States. But the reform group was able to defeat — in the House and Senate — a Wall Street-Treasury drive to eliminate the 30 percent withholding tax on interest and dividends paid to foreigners, a drive that made no tax or even financial sense.

the entire area. It would also permit the end of DISC. Current taxation of foreign income and a rational foreign tax credit would thus be the basic structure of the income tax for this area.

B. *Estate and Gift Taxes*

1. *The Legislative Process*

The revisions in the estate and gift tax, major in scope and long overdue, are really a chapter in farm politics. Everything done is inexplicable without a recognition of the influence of the farm vote. With that recognition as the centerpiece, the various parts can then be fitted together.

The story is lengthy and a concentrated summary will have to suffice. Some elderly farm families were suddenly finding themselves facing potential estate tax problems as the rapid rise in farm land values took their assets over the \$60,000 estate tax exemption. This rapid rise covered land near growing urban areas and suitable for non-farm development. But the rise also extended to farm land itself as farmers sought to expand their holdings and as some non-farmers sought such land. These elderly farm families had not thought about estate planning techniques, unlike many farm families in younger age groups, and hence were unprepared for the coming collision with the estate tax. Their representatives saw the solution to be an increase in the \$60,000 estate tax exemption, and pressure was concentrated on that point. President Ford at first responded with milder suggestions, along the lines of extended tax payment periods. But he soon succumbed to the politics of the situation and was urging an increase in the \$60,000 exemption to \$150,000. Stories began to spread about farm families forced to give up the values of farm life in order to pay the estate tax. The stories were really not documented, and probably the need to allocate farm estates between the children who preferred farming and those who did not was causing far more difficulties for farm families than the tax situation.³¹ But the pressure spread and large numbers of legislators were soon pledged to estate tax relief for farmers.

The farm representatives were generous. They thought that small business — closely-held family business enterprises — deserved similar treatment. Indeed, all estates deserved an increase in the exemption level, for “inflation” — that friendly genie of those seeking tax preferences — had, they said, outdated the \$60,000 level. Reformers attempted to inform the Congress that even at the \$60,000 level only 7 percent of

³¹ See, e.g., Address by Mr. Woods, Public Policy Specialist, Extension Service, USDA, *Property and Estate Taxes — Their Potential for Affecting Land Allocation Decisions*, Workshop on Land-Use Planning in Rural Areas, Raleigh, N.C. (Nov. 16, 1976). He stated that it “cannot be said that farmland is being diverted from agricultural uses on any substantial scale as a result of death tax burdens.” An Iowa Law Review study of farm estates found that most family farmers, once they recognized the estate planners problem — usually in their mid-50’s — solved those problems before death by estate planning techniques commonly used in small family businesses. Note, *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 IOWA L. REV. 794 (1974).

decedents had net assets sufficient to incur an estate tax, so that the estate tax hardly cut a wide swath in an affluent society. A \$150,000 exemption would reduce this 7 percent to less than 2 percent, and would cost about \$1.6 billion, or 20 to 30 percent of current estate tax revenues. Of course, most estates subject to the estate tax contain diversified securities as the principal assets and hence neither incur liquidity problems nor portray the American virtues of farm life and family businesses. But the families involved were initially quite content to silently watch the lobbying by the farm groups.

Estate tax revision thus made its way to a prominent position in the Ways and Means Committee agenda in 1976. Hearings were held in March 1976. The Treasury contented itself with urging a \$150,000 exemption, an unlimited marital deduction, a rate schedule starting at 30 percent, and opposition to any change in the treatment of appreciation transferred at death. As a result of outside suggestions, the Committee for the first time heard data on the concentration of wealth in the United States.³² It also heard some queries as to just why, given proposals for a much broader marital deduction to protect the surviving spouse and an orphan's deduction, adult children needed such large protection from an estate tax. But these aspects were lost in the farm pressures. So the tax reformers on the Committee and the Joint Staff countered by widening the area of estate tax revision and set forth various reforms as the price that could be paid for the increased estate tax exemption level. The reforms included unification of gift and estate tax rates, an increased marital deduction (this of course met no opposition), a change in the escape from income tax of appreciated assets transferred at death (basis step-up), and an end to the escape from estate tax provided through "generation-skipping" transfers. The Joint Staff also devised a credit-against-tax form of exemption, which satisfied the farmers and reduced the revenue cost of the increased exemption.

At this stage the other important pressure group involved in the estate tax was triggered into action — the American Bankers Association. Reform attacks on generation-skipping trusts and step-up of basis at death had been the crucial concerns of this organization and it was fully prepared to mount a defense. The public interest groups were in a dilemma. They preferred no estate tax revision, hoping for a better day if a Democratic administration took over the White House. But the farm pressure appeared strong enough to achieve the goal of increased exemption, so that the consequent revenue loss therefore offered a chance to push these offsetting estate tax reforms and thus accomplish something. The farm pressure thus forced the hand of the reformers and pushed Chairman Ullman into trying to achieve an overall revision.

A bill — H.R. 14844 — did emerge from the Committee and reached the House floor. But here it foundered, caught in the cross current of a reform move to permit only two floor amendments — a split credit

³² Statement of Prof. James D. Smith, in Hearings on Federal Estate and Gift Taxes, Ways and Means Committee, 122 Cong. Rec. 1309 (1976).

of \$29,800 for everyone plus \$25,000 more for farmers and family business as against the single \$40,000 credit (exemption level of \$153,750) in the bill, and the elimination of a \$1 million exclusion for transfers from parent to child to grandchild in the generation-skipping rules — and a counter move desiring a vote on the carryover of basis at death provision in the bill and other provisions. Chairman Ullman withdrew the bill. In the meantime, the Senate Finance Committee had included some estate tax provisions in the major tax reform bill. These revisions principally were a credit of \$50,000 (exemption level of \$197,667), an increase of the marital deduction to a \$250,000 minimum as in the House bill, and the generation-skipping provisions of the House bill but without any exclusion. On the Senate floor the only serious debate was over a reform move to obtain the split credit. But the farm groups, backed by the Treasury, did not want to be caught in the exposed position of having the higher credit, and therefore defeated this tactic on a vote of 50-34. Less than 3,000 families would have enjoyed the higher credit, and so these families brought the blessing of the higher credit, at an added revenue cost of over \$1 billion, to all the other families (about 150,000) benefited by that higher credit.

Since the House tax reform bill contained no estate tax provisions and the Senate version only a few provisions, estate tax revision of the scope of the separate House bill (H.R. 14844) really was not in Conference. Nor did the American Bankers Association want any action, and the reform groups also would have been content to let the matter end. But the tax reform bill appeared to be the only vehicle to achieve the goal of the farm group and that group held the commanding position. Its supporters in the Conference might well have stalled or blocked the tax reform bill itself, as the legislative session was nearing a close. Thus, at the last minute estate and gift tax revision along the lines of the House bill, but with modifications, was hastily added to the tax reform bill. The parliamentary situation required a separate vote in the House and Senate. The only debate came in the House, where opponents of the carryover of basis provision sought to defeat that change. A defeat would have unravelled the entire structure and the reformers joined the farmers to sustain the provision, and hence the bill, by a vote of 229 to 181.

So farm politics — benefiting perhaps 3,000 farm families — brought about far-reaching revision in the estate and gift taxes, taxes which had resisted change for over a quarter century. Along with this revision came the major change in the income tax treatment of appreciation at death. An interesting little noticed aspect of this legislative history is that while farm groups led the drive, the Department of Agriculture and their farm experts were strangely silent throughout. The few glimpses of the views of the experts in that Department indicate they considered the farm lobby goal of increased exemption not in the best interests of the American farm community. These experts apparently did not see any real threat to the family farm under the existing rules, and instead saw the increased exemption as concentrating farm land

holdings in fewer families and thus putting a barrier in the way of new, young entrants into farming.³³ The Department of Agriculture thus seems to have let the political winds blow over its head and allow the Treasury Department to embody the "agricultural wisdom" of the administration.³⁴

With this legislative background we can consider the revisions themselves.

2. *The Exemption Level*

The new system has a unified credit of \$47,000 applicable overall to gifts and bequests (exemption level of \$175,625) phased in over a five-year period. This level confines the estate tax to about 1.7 percent of decedents. The estate tax marital deduction is increased to a minimum of \$250,000, so that a net estate of \$425,000 can pass tax free to a spouse. There is an orphans' exclusion of \$5,000 times years under age 21 for each orphan. The credit will cost about \$1.5 billion by 1981 and the marital deduction only \$181 million (in view of the credit).³⁵

³³ See, e.g., Address by Mr. Woods, *supra* note 31:

Preferential property tax treatment of agricultural land is most often sold to the electorate as having the objective of preserving farmland but available empirical evidence suggests that in many, if not most, cases their real, though unstated, objectives may simply be to secure benefits for particular owners of farmland. The same kind of sales job was largely responsible for the extent to which farmland was accorded special estate tax treatment in the recent Federal tax reform legislation.

In its early years, our Nation took conscious action to prevent the development of a hereditary landowning class such as was found in European countries. Examples are laws prohibiting primogeniture (the bequeathing of land, intact, to the eldest male heir) and entailment (legal provision that property must remain in a family through subsequent generations). Some of the new estate tax provisions move us back in this direction and will assuredly make it even more difficult for young persons from non-landowning families to enter agriculture.

While the limited evidence available to us indicates little, if any, past interference with rural land allocation decisions, recent tax changes show the potential, at least, for some future distortion. And some of these distortions or results do not seem to be consistent with stated national goals.

³⁴ The Department of Agriculture did send an adverse report on adoption of "use value assessment" (see note 35 *infra*), but this document seems to have just been filed and kept from sight.

³⁵ There is also a new rule — desired by the farm group — for jointly-held property under which property transferred as a taxable gift from one spouse to a joint holding of the spouses is only included at one-half value at death. It is thus a special type of marital deduction. The farm groups also secured changes in the valuation of farmland which would seem significantly to reduce the value to be included in the gross estate, with recapture provisions if farm use ceases, and a new rule for extensions of time for payment: if the value of the farm is 65 percent of the adjusted gross estate, no tax is due for five years and then payment can be made over ten years at 4 percent interest. Just why is the Treasury Department and not the Department of Agriculture making loans to farmers?

The farm "use value" change can have serious consequences. See Address by Mr. Woods, *supra* note 31:

The use value assessment feature, even though it cannot reduce a gross estate by more than \$500,000, provides its benefits to all farm estates who qualify. Thus, the real size of this apparent half million dollar benefit is directly proportional to the marginal tax bracket of the estate.

Without this addition to the Federal estate tax law, other changes appear to

3. *Unified Rates and a Unified Credit*

The revision made the commendable step of treating gift and estate tax rates as a cumulative continuum, with the unified credit described above. Gifts made within three years of death are to be grossed-up in the estate by the tax on the gift.³⁶ Gross-up is obviously the proper approach (the estate tax is automatically grossed-up) and the failure to gross-up gifts made before three years of death is an important defect. The failure seems due to an inability to make the Committee really aware of the significance of gross-up and to grasp that the mechanics, while perhaps difficult when described orally, are not that complex for the practitioner.

The gift tax and the estate tax are not really unified into a single transfer tax, as under the United Kingdom approach. Instead, we still have the overlapping rules of when a gift is complete or incomplete and when a taxed gift is to be also taxed in the estate. Thus this technically over-complex area is still in need of improvement.

Despite a \$47,000 credit against tax involving an exemption level of \$175,625, the rate scale starts with a bracket of \$0-10,000 at an 18 percent rate and includes six more brackets until a 32 percent rate is reached at \$150,000 (cumulative tax under the table at this point is \$38,000). This 32 percent rate is in most cases the starting rate above the zero bracket represented by the \$47,000 credit. The graduated rates up to that point seem window-dressing to take the focus off of the 32 percent rate.³⁷

facilitate the intergeneration transfer of family-size farm units, but seem to be fairly neutral with respect to land use allocations between farm and non-farm uses. But the use value assessment provision provides substantial incentive for holding land in agricultural uses for at least 15- to 20-year periods without regard to whether this is, in fact, the land's best use.

Moreover, a tax shelter is created in farmland. The preferential assessment feature was originally justified on the basis of easing the plight of farmers in suburban fringes where pressure from non-farm uses and speculative buyers had bid land prices up beyond what farmers could afford to pay. We all know that these situations exist but, if the data provide an accurate picture, they are the exception rather than the rule. Farmers adding to their existing units are apparently the biggest single contributor to today's high farmland prices. And the benefits from the use value assessment feature, which will probably reduce farmland valuation, for estate tax purposes, from 40 to 60 percent will quickly be capitalized into land values, thus adding further pressures to the rising farmland market.

The primary beneficiaries of the tax shelter created will, in all likelihood, be existing farmers who have family heirs desirous of continuing the farming operation. It is difficult to predict, at this time, the extent to which wealthy non-farmers will enter agriculture to take advantage of the sizeable tax shelter. But there is a definite incentive for the "gentleman farmer!"

³⁶ The gift is also to be valued at death, though why this should be the rule is not stated.

³⁷ A starting rate of 21 percent for a bracket \$0-175,000 would have satisfied the \$47,000 credit. The statutory rate scale seems to be applicable at only two points — a deemed transfer prior to the death of the deemed transferor where the statute does not permit the use of the credit, and where a donor elects not to use the unified credit for gift tax purposes in order to in effect utilize the non-gross up aspect of the gift tax and lessen the taxable gross estate (which is subject in effect to gross-up).

4. *Generation-Skipping Transfers*

The House Committee Report stated the correct criterion to apply in fashioning structural rules to deal with the problem of generation-skipping transfers. The Report (accompanying H.R. 14844) stated:

The purpose of the Federal estate and gift taxes is not only to raise revenue, but also to do so in a manner which has as nearly as possible a uniform effect, generation by generation. These policies of revenue raising and equal treatment are best served where the transfer taxes (estate and gift) are imposed, on the average, at reasonably uniform intervals. Likewise, these policies are frustrated where the imposition of transfer taxes is deferred for very long intervals, as possible, under present law, through the use of generation-skipping trusts . . .

Your committee recognized that there are many legitimate nontax purposes for establishing trusts. However, it also believes that the tax laws should be neutral and that there should be no tax advantage available in setting up trusts.

Generation-skipping transfers as used by estate planners clearly ran counter to this criterion. Under such a transfer, a trust could be created to distribute income or principal to children, then to grandchildren and on to great-grandchildren, with no estate tax (subsequent to the creation of the trust) as enjoyment of the property passed from generation to generation. The length of these trusts was determined by the local law Rule Against Perpetuities and many a trust now in existence will run for a hundred years. Indeed, in Wisconsin there are some perpetual trusts. Obviously the escape from tax obtained under generation-skipping transfers meant the estate tax failed to reach the wealthiest families, and as Professor A. James Casner said in the House Hearings, these transfers turned the estate tax into a voluntary levy.

The reformers had an imperative goal in sight therefore when they sought to tax these transfers. But the technical rules adopted in the Act fall miserably short of the goal. The Act permits unlimited outright transfers that skip a generation, as a grandfather's gift to a grandchild. It then equates outright trusts with outright gifts, and thus allows grandfathers to create trusts for grandchildren thereby skipping the children, or for great-grandchildren. Clearly a wealthy family could thus combine a series of separate layered trusts — for children, for grandchildren, and for great-grandchildren — that would satisfy family planning and once again permit the estate tax to be skipped from generation to generation. The Act's definition of generation-skipping trusts permits this "layering," since to be covered a trust must have two or more generations of beneficiaries. But even in such a covered trust, there are major gaps. Thus, in a trust for children and then for grandchildren, there is a \$250,000 exclusion of trust corpus for each child involved in the trust. Further, distributions of income to the grandchildren go un-taxed.³⁸

³⁸ The generation-skipping provisions technically constitute a separate tax, so that <https://engagedscholarship.csuohio.edu/clevstlrev/vol25/iss3/2>

The impression of many lawyers is beginning to be that the generation-skipping provisions will not seriously constrain estate planning for wealthy families. If the estate tax is not to reach such families, what is its purpose? What were the causes of this failure, given the stated goal? One factor was the opposition of the American Bankers Association, which urged that the skipping of at least one generation should be allowed. Yet the Committees seem to have decided against that view in their decision to grant only the \$250,000 exclusion. Another factor may have been a combination of the decision to permit outright gifts and the failure of the Committee Members to realize that an outright trust is a far different arrangement. The non-coverage of outright gifts (itself a dubious decision and one that should contain at least a maximum limit) should not therefore automatically have led to the noncoverage of outright trusts. A gift involves a living donee and is an inflexible device. A trust can be established for unborn beneficiaries and affords great flexibility as to dispositions of income and principal, number and treatment of beneficiaries, and the like.³⁹ Another factor perhaps was the apparent inability of the technicians really to focus House Committee attention on the great wealth involved in these transfers. Thus, by a close vote the House Committee had decided to exclude children-grandchildren trusts. That decision was suddenly reversed, and a \$1 million limit adopted — which in Conference became the \$250,000 exclusion — when some Members learned (not from the Staff) how much was included in these trusts — for some families at least a half billion dollars.⁴⁰ Certainly the Treasury was no help in securing adequate provisions. The statement of its Assistant Secretary for Tax Policy as to generation skipping and other reforms — “Why should the federal government legislate on these (other) things. . . . Why should it horse around with social issues like this?”⁴¹ — is an unmatched classic in the annals of Treasury tax policy. The various bar groups were of no assistance, for their input was a pious urging of caution and really no action lest the statute become too complex, though why lawyers capable of producing the complex provisions of these trusts were worried about complexity must remain a mystery.

Generation-skipping provisions of the Act are thus in need of correction, and prompt correction before the new devices become a familiar pattern and produce new pleas not to disturb the status quo. There is, moreover, another need for prompt revision, and that is to correct the

the transfer tax system consists of a gift tax, an estate tax, and a generation-skipping tax.

³⁹ The United Kingdom transfer tax reaches outright trusts but not outright gifts.

⁴⁰ For example, the DuPont family has generation-skipping trusts established by William DuPont and his wife in the nineteen-twenties that appear to involve close to \$500 million. See *Estate of William DuPont, Jr. v. Commissioner*, 63 T.C. 746 (1975), and data prepared therefrom by Professor George Cooper of Columbia Law School. The Rockefeller families have generation-skipping trusts totalling over \$600 million established by John D. Rockefeller, Jr. in 1934 and later years for his six children (from material prepared by Gerald Jantscher from the Nelson Rockefeller nomination Hearings).

⁴¹ Statement of Assistant Secretary Walker, as quoted in Balz, *Congress Looks at Death and Taxes But Outlook is Far From Certain*, 11 NAT'L J. 328, 330 (1976).

Act's grandfathering of all existing generation-skipping trusts.⁴² Again the reason appears to lie in the failure to make the Committees focus on what is at stake. The Committees undoubtedly heard the arguments of supposed unfairness in disturbing arrangements already made and in some cases irrevocable. But who acquainted the Committees with the huge amounts involved — over hundreds of millions for some families that will go untaxed for fifty or more years?⁴³ And who pointed out that no real unfairness would be involved in covering these trusts? To be sure there would be a tax due on the future death of a beneficiary as enjoyment passed to another generation, but that tax would come from the trust assets. In essence, this comes down to a future increase in estate taxes for these transfers, and under the circumstances — especially in contrast to the complete generosity of continued tax escape for these vast amounts of wealth — such tax imposition is justified and required.⁴⁴

5. *Carryover of Basis at Death*

The carryover of basis at death solution of the Act for the previous escape from income tax of appreciation in assets transferred at death is apparently a solution no one desired. The reformers desired the transfer at death to be treated as a constructive sale, with income taxation similar to that on an actual sale.⁴⁵ The American Bankers Association really preferred nothing, offered a flat separate 14 percent tax on the appreciation, and saw carryover of basis as a dismal complication. The farm group saw any change as a step clouding the atmosphere of their hard-won increase in the estate tax exemption level. The Treasury, true to its rigid status quo policy, desired that nothing be done. Carryover of basis is indeed the most complicated of the three possible positions — status quo, income taxation at death, and carryover. And yet despite its being unwelcome to every group and subject to most of the objections raised against the other solutions, carryover of basis survived as the chosen solution.

Clearly carryover of basis is a compromise position. The reformers could not obtain more and barely defended carryover, winning a House floor vote of 229-181. Even to accomplish this they had to concede the grandfathering of all appreciation prior to December 31, 1976. But the status quo adherents could not obtain less than carryover. Years of reform opposition to the existing step-up in basis at death had their effect and legislators were apparently aware of the large amounts of appreciation escaping income tax.

Clearly also, carryover of basis has its problems. For reformers it

⁴² The Senate Committee did have a 10-year phase-out of this grandfathering, but this limit quickly disappeared without debate on the Floor.

⁴³ The Joint Staff estimates that the provisions will not be fully effective for 50 years.

⁴⁴ There are, in addition to this policy issue, a number of difficult technical questions arising from the drafting of the "grandfather" provisions.

⁴⁵ The resulting income tax liability would be a reduction in the value of the gross estate.

means in many cases more deferral and an obstacle to sale as appreciation builds up. Will IBM stock become a family heirloom never to be sold, as Representative Conable said in arguing against carryover? (On the other hand, will parents in some situations desire to conclude sale or tax-free merger arrangements themselves feeling they can do better than their heirs?) For those forced to sell assets to pay the estate tax, carryover is the same as the constructive sale proposal.⁴⁶ For trust companies and other executors carryover is a most complex matter. Assets with different bases, different carryover rules, and different gain characterizations must be carefully allocated among legatees; records must be kept longer. But one cannot weep for the trust companies. They chose to defeat the constructive sale solution, using the nonsense argument that the solution was regressive because the larger the estate the larger the amount of income tax at death borne by the government (which is, of course, true of the entire income tax) and suggesting instead an arbitrary ad hoc solution. They must now pay the penalty of their opposition.

The question remains how long we must live with the carryover compromise. Perhaps its complications will lead to the logical move to the constructive sale solution. At least, since carryover is better than step-up in basis, let us hope that future movement is not backwards in this area.

6. Overall

It really does not pay to ask the question of how reformers should view the balance struck in the estate and gift tax area of the 1976 Act. The large increase in the exemption level severely and wrongly reduced the coverage of these taxes. The unified rates greatly strengthened the rate structure, but the failure to have full gross-up under the gift tax is a considerable defect. The generation-skipping provisions sought a proper goal but then ended as woefully inadequate implementation. Carryover of basis falls considerably short of taxation at death but did eliminate step-up in basis.

But the Act is law however one sees the balance. The important point is that the paths to reform remain clear: complete gross-up of the gift tax; real strengthening of the generation-skipping provisions and elimination of grandfathering except for a period, say 10 years, of adjustment; moving from carryover of basis to taxation at death.⁴⁷ Per-

⁴⁶ Under carryover, the estate tax on the appreciation is an addition to asset basis. Hence, if income tax rates are the same before or after death, sale before death or sale after death comes out the same way. An exception is a section 691 capital gain installment sale before death, where section 691(c) erroneously allows as a deduction (not an addition to basis) the death taxes on the appreciation and hence, considering the 50 per cent capital gain deduction, overcompensates for the estate tax.

⁴⁷ A desirable technical revision would turn the gift tax and the estate tax into a unified transfer tax, with coordinated rules on when a transfer is to be taxed and, if possible, appropriate correlation with the income tax. Probably the criterion should be that of "hard to complete" transfers, since the crucial factor (given complete gross-up and a unified rate structure) is the time of valuation for transfer tax purposes, though this is off-

haps a Treasury seeing the real issues involved and viewing reform in this area as something more than "horsing around," can present with clarity, vigor, full data, and real examples, the case for needed improvement.

A Treasury concerned with effective gift and estate taxation should not limit its efforts to these changes. While the revision spotlight has focused on the matters in the 1976 Act, in the shadows sophisticated estate planners are using arrangements to transfer from parent to children wealth, still in the process of being created, without, however, incurring any transfer tax. This is the world of tax-free recapitalizations of existing family enterprises or the creation of new family enterprises where the children obtain the growth equity stock, the father keeps the voting control, and the father continues in executive command to build the business. His efforts increase the value of the children's common stock and at his death they are millionaires — but no transfer tax will have been paid on their millions.⁴⁸ In addition, there are other devices coming into vogue, such as front-end charitable trusts for really wealthy families; installment sales to children freezing values by permitting annual remission of the purchase price and in some cases the opportunity for the parents to produce appreciation in the assets sold; ways of utilizing the generous valuation rules of the courts that pile one valuation discount on another so that in the end properties of large value in real use by the family are seen by the IRS or the courts as worth far less.⁴⁹ There is thus much more work to be done by the Treasury than just correction of the 1976 Act if it desires to achieve effective taxation of wealth in the United States.

III. FUTURE STUDIES

The 1976 Act contains an unusually large list of reports and studies desired by the Congress in the tax field. These are, briefly stated:

- Joint Committee on Taxation to study simplification and indexing of the tax laws, including whether the rates of tax can be reduced by repealing any or all tax deductions, exemptions, or credits. (§ 507)
- Joint Committee, in consultation with Treasury, to study the cost effectiveness of different kinds of tax incentives, including an analysis of the most effective ways of using tax cuts in a period of business recession to stimulate the economy. (§ 2133)
- Joint Committee to study the treatment of single and married persons. (Conference Committee Report, page 507)

set to some extent by the deferral of tax involved as respects the particular transfer and its effect on the rate bracket for subsequent transfers.

⁴⁸ The 1976 Act does contain a provision reversing *United States v. Byrum*, 408 U.S. 125 (1972), and taxing a trust where the transferor retains voting control of the stock in the trust. But the apparent limitations of that change — does it reach recapitalizations? — underscore the much larger area of avoidance that remains to be dealt with.

⁴⁹ These matters are discussed in Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, to be published in 77 COLUM. L. REV. (1977); S. Surrey, *The Federal Estate and Gift Taxes in the United States — Some Current Policy Issues* (Narobi Conference-Associated Business Programmes Limited, London 1976).

- Treasury directed to publish annually data on taxes paid (read not paid) by individuals with high real incomes. (§ 2123)⁵⁰
- Joint Pension Task Force to study employee stock ownership plans. (§ 803)
- Joint Committee on Taxation to study expansion of Individual Retirement Accounts to individuals not covered. (§ 1509)
- Treasury to report on effects of amendments regarding Puerto Rican tax-exempt operations. (House Committee Report, page 259; Senate Committee Report, page 282)

In addition, the House Committee has Task Forces studying the treatment of foreign income and capital formation.

What is future portent and what is burial in these projected reports and studies? All items in the study list under the 1976 Act do make sense and merit the study requested. Thus the "simplification" study opens the whole area of whether it is possible to trade off elimination or curtailment of the tax expenditure personal deductions and credits for rate reduction or, alternatively, a major increase in the standard deduction or a floor for such deductions. Only some such broadscale trade-off will bring a degree of simplification to the tax return. The Treasury report on high income individuals, properly handled, should provide strong impetus to further efforts to close upper-bracket tax escapes and to obtain a rationalization of the several sets of tax rates. A study of "tax incentives" broadly viewed can mean real cost-benefit and equity analyses of many tax expenditures as compared with direct program alternatives or even with no federal assistance. The study of how to treat single and married persons may possibly lead to some settled conclusions in this troublesome area.⁵¹ The Puerto Rican study, if done with the new government in Puerto Rico and with a genuine desire to get at the weaknesses, for Puerto Rico and the United States, of the present provisions (section 1051 of the Act) and their unwarranted tax escapes for the drug companies and others with operations in Puerto Rico, could throw light on an area that the previous Puerto Rican government and our own Treasury and Joint Committee Staff have shielded. The House Task Forces on foreign income and capital formation could add knowledge to these areas but it is likely that intensive Treasury study will be necessary.

The above list is not of course a full blueprint of things to be done to improve the tax system. But it does contain a number of items that properly pursued could mean an impressive start. Certainly this is so if there are added the various matters, described earlier, where the 1976 Act has fallen short of proper goals.

⁵⁰ See 122 CONG. REC. S10648-662 (daily ed. Jun. 25, 1976) for some Treasury data on high income taxpayers supplied at the request of Senator Kennedy. The data indicate the importance of the deduction for interest but are not complete enough to show the types of items with which the interest is associated. The data also omit information not shown on tax returns.

⁵¹ Does any portent lie in the 1976 Act section 1501 allowing a separate IRA account for a non-working spouse?

IV. CONCLUSION

What should be said in concluding these reflections on the 1976 Act? Overall the verdict must be on the plus side. The Act does achieve reforms in a number of areas and the serious setbacks are relatively few. The credit goes to the reform groups on the Tax Committees and in the Congress, the Budget Committees and the Congressional Budget Office, the Joint Committee Staff, the few public interest groups, the dogged efforts of a few tax reform-minded Representatives and Senators, and in ways not really fully fathomable, to the efforts, differently pursued, of Chairman Ullman and Chairman Long. The Act in this sense is the story of a congressional reform effort pushed by a Democratic membership committed, in varying measure and with varying understanding of what was involved, to tax reform.

But the Act is also a story of opportunities lost. For its limited success is a verdict on the limitations of congressional reform unaided by executive branch commitment to that same reform. We can see in almost every failure to accomplish more than was done in the Act the absence of the power that lies in executive leadership. That power encompasses the dramatization of the need for reform, the amassing of data and examples that sweep away opposition debating points, the technical skills in shaping provisions and moving around obstacles, and above all the persuasion of Members both to stand with the President and the Treasury and to use the desires of the Executive as a safe refuge against the pleas of the opposition lobbyists.

The limits of the steps taken in the 1976 Act thus lay in the absence of one of the three ingredients necessary to genuine tax reform. These ingredients are a public interested in tax reform, a moderate-liberal Congress willing to respond to that interest, and an executive branch really concerned to achieve tax reform and provide leadership. The nineteen-sixties saw in the Democratic administration the third ingredient, and with the 1969 Act the beginnings of the first and second ingredients. But then, as the congressional and public interest in tax reform grew in the nineteen-seventies, the concern for tax reform disappeared from the executive branch, and that missing ingredient held the 1976 Act to its limited gains. But the ingredients of an interested public and a moderate-liberal Congress still exist. There is also the prospect once again of an executive branch desirous of obtaining tax reform. Thus, for the first time in many years of tax history, there is the hope that all three needed ingredients will be present at the same period. If this is indeed the situation, then we are on the way to much more reform than that seen in the 1976 Act.