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REVENUE ACT OF 1962

1498—

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 10650

AN ACT TO AMEND THE REVENUE ACT OF 1954 TO PROVIDE A CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY, TO ELIMINATE CERTAIN DEFECTS AND INEQUITIES, AND FOR OTHER PURPOSES

APRIL 3, 4, AND 5, 1962

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REVENUE ACT OF 1962

TUESDAY, APRIL 3, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 o'clock a.m., in room 2110, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Douglas, Gore, Hartke, McCarthy, Williams, Carlson, Curtis, and Morton.

Also present: Elizabeth B. Springer, committee clerk; and Colin F. Stam and L. M. Woodworth, of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Walter A. Slowinski of the Chamber of Commerce of the United States.

Take a seat, sir, and proceed.

STATEMENT OF WALTER A. SLOWINSKI, APPEARING ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. SLOWINSKI. Mr. Chairman and members of the committee, I am Walter A. Slowinski of the law firm of Baker, McKenzie & Hightower of Chicago, Ill., and Washington, D.C., appearing on behalf of the Chamber of Commerce of the United States as a member of its committee on taxation.

I am an adjunct professor of comparative tax law at the Georgetown Graduate Law School in Washington, D.C., and a lecturer in domestic and foreign tax law at the University of Virginia Law School in Charlottesville.

The chamber's board of directors and committee on taxation have met regularly during the current year on the changing tax proposals to be certain all points of view have been given an opportunity for full expression.

We request permission, Mr. Chairman, to file another more detailed statement later in these hearings.

We are anxious to give all our members an opportunity to comment on H.R. 10650. For this reason our detailed statement will not be completed until April 27. We request permission to have it inserted at the end of the record for that day's testimony.

The CHAIRMAN. Without objection that will be done.

Mr. SLOWINSKI. The chamber's position on major sections of H.R. 10650 is as follows:

SECTION 2—THE INVESTMENT INCENTIVE CREDIT PROPOSED SHOULD BE REPLACED BY MORE REALISTIC DEPRECIATION ALLOWANCE PROVISIONS

At yesterday's hearings the Secretary of the Treasury indicated the Chamber of Commerce of the United States had not taken a position on the investment incentive credit at its last tax policy committee meeting. This is in error. The chamber has consistently opposed the investment incentive credit in each of its several forms which have been considered by the chamber's committee on taxation as well as its board of directors.

In each case the vote has been adverse to this type of investment subsidy.

The chamber again recommends against the adoption of this novel and untried preferential tax credit subsidy for business. It is unnecessarily complex and it will be difficult to administer such new concepts in our code as "section 38 property," "qualified investments," "carryover adjustments," and "unused credit years."

The opposition by the chamber to the tax credit is not influenced in any manner by the other proposals contained in H.R. 10650. If all other sections were stripped from this bill, the position of the chamber in opposition to the tax credit as a subsidy would remain.

The investment incentive credit has no place in an income tax law. Its rate (now at 7 percent) and its tenure (somewhat uncertain) continue to be uncertain in the light of the last-minute downward changes which occurred during the last few days of March in the Ways and Means Committee.

The credit gives preferential tax treatment to certain taxpayers in favored groups.

It may actually be a windfall to a business which had already fortuitously planned to purchase new facilities later in 1962. On the other hand it will work against small businesses or lose companies which have no current funds for expansion or no taxable income to be offset by the credit.

More importantly, the adoption of the credit at a revenue loss of at least $1.175 billion may prejudice and delay meaningful depreciation reform promised by the Secretary of the Treasury this spring.

Even as little as a 10-percent improvement in depreciation rate will mean approximately $3 billion in additional depreciation deductions. It is questionable whether this added $1.5 billion loss in revenues can be supported by the economy in the light of the $1.175 billion loss on the investment credit.

As an alternative to the investment credit, the chamber strongly endorses a basic revision upward of depreciation rates and a simplified classification of depreciable facilities. An initial investment allowance may also be desirable.

Many countries provide such initial allowances to measure reasonably the cost of first-year obsolescence. This type of initial allowance has already been adopted in our Internal Revenue Code on a small scale in the 20-percent first-year depreciation allowance for small business in section 179 of the code, but it is limited to $10,000. The

chamber recommends that Congress now remove the $10,000 limitation in section 179 to provide the stimulus and incentive the President is seeking.

SECTION 3—DEDUCTIONS FOR LEGISLATIVE ACTIVITY SHOULD BE IMPROVED

The chamber believes that section 3, as presently contained in H.R. 10650 is neither an adequate nor a proper solution to the problem of legislative activity deductions.

In lieu of section 3 of H.R. 10650, it recommends the substitution of S. 467 introduced by Senator Hartke. A similar bill was reported favorably and unanimously by the Ways and Means Committee of the 86th Congress.

The chamber proposes a general legislative rule which would state that:

> No expense which otherwise qualifies as a deduction relating to trade or business expenses (including, but not limited to, dues and other amounts paid to any organization) shall be disallowed as a deduction merely because paid or incurred to support or oppose or otherwise influence action by the Congress by any legislative body of a State, a possession of the United States, the District of Columbia, or any political subdivision of the foregoing, with respect to any legislative or constitutional proposal, or to support or oppose or otherwise influence action of the voters with respect to any legislative or constitutional proposal submitted or proposed to be submitted to the voters by initiative, referendum, or similar proceeding.

The general rule would not be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise) for participation or intervention in any political campaign on behalf of, or in opposition to, any candidate for public office.

SECTION 4—ENTERTAINMENT EXPENSE PROBLEMS CAN BE HANDLED BY VIGOROUS ENFORCEMENT OF EXISTING LAWS

The complications of section 4 will make it almost impossible for the average businessman to determine and substantiate his right to a deduction for legitimate business expenses.

There should be no objection by taxpayers to a requirement that business expenses be substantiated so long as such requirement is reasonable.

However, most of the new rules in H.R. 10650 are too complicated for the average taxpayer and could create disrespect for an unreasonable tax law as well as an undermining of our self-assessment system of taxation.

Vigorous enforcement of existing provisions will accomplish the objective and avoid penalizing all business taxpayers for the abuses of a relative few.

On a related problem, the expense incurred with respect to a facility used for business entertainment purposes, such as a car, should be allowed to the extent that it is so used and can be substantiated as a proper business deduction. If the usage is less than 50 percent, for instance 20 percent, then such portion should be allowed.

SECTION 8—MUTUAL SAVINGS BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND COMMERCIAL BANKS SHOULD BE TAXED EQUITABLY

The chamber supports measures which would provide that commercial banks, mutual savings banks, and savings and loan associations be subjected to the Federal corporate income tax in such fashion as to contribute to capital and reserve adequacy and to insure competitive equality to the extent that the Federal tax is a competitive factor.

SECTION 11—"GROSSING UP" SHOULD NOT BE ADOPTED

The adoption of section 11 of H.R. 10650 involving the so-called grossing-up rule would overturn principles of some 43 years' standing, upset long-established relations in our tax treaties, and penalize foreign trade particularly in the less developed areas. Here again the wisdom of changing long-established rules to gain a temporary economic objective should be carefully considered.

SECTION 12—SECTION 911 INVOLVING EARNED INCOME FROM WITHOUT THE UNITED STATES SHOULD NOT BE CHANGED

Factual statements will be submitted to this committee by American Chambers of Commerce in foreign countries defending the present earned income exclusion of U.S. citizens working abroad.

With your permission, we should like these incorporated into the record of the hearings since some of these groups did not receive word of these hearings in time to apply for scheduling on the witness list.

The CHAIRMAN. I believe we have several scheduled to appear May 3. If written statements are received from others, they will, of course be inserted in the record of the hearings.

Mr. SLOWINSKI. Thank you, sir.

SECTION 13.—THE FOREIGN INCOME PROVISIONS OF SECTION 13 SHOULD BE ELIMINATED

Mr. SLOWINSKI. Although the chamber is as interested as the Congress in removing any possibilities for tax avoidance in foreign operations by U.S. companies or shareholders, it is clear the new provisions of section 13 are designed principally to discourage any further U.S. investment abroad even in less-developed countries.

To the extent the Treasury Department is interested in abolishing tax havens, as are we, it can do so through the new provisions of section 482(b) in section 6 of the bill, coupled with the presently effective provisions of section 482 covering allocation of income between related taxpayers.

The new section 13 will remove the possibilities for U.S. corporations competing in full and fair competition with foreign corporations on foreign soil.

However, the President has specifically stated that he does not want to—

penalize legitimate private investment abroad, which will strengthen our trade and currency in future years.

Regardless of the constitutionality or unconstitutionality of this proposed law—and the courts have challenged the constitutionality of taxing income which has not yet been received—such penal measures as contained in section 13 cannot but succeed in changing our Nation's attitude toward private investment in developed and less-developed areas of the world.

Foreign competitors will continue to employ multicorporate weapons in their war against U.S. private enterprise to drive U.S. corporations from the markets of the world in which we should have a fair share.

Tying both hands behind the backs of U.S. corporations will not help the U.S. trade and currency in future years as the President suggests.

U.S. private investment asks for neutrality—including the opportunity to compete with foreign corporations on foreign soil under the same rules of foreign trade and taxation. To set up artificial geographical rules as in H.R. 10650 is to restrict U.S. companies without limiting their foreign competitors who are in direct competition worldwide.

As an example, if a Brazilian subsidiary of a U.S. corporation purchases property manufactured in Argentina by a related company and sells it to anyone for use, consumption, or disposition in Chile, the entire income is foreign base company income in the United States.

We submit this ignores the realities of the Latin American free trade area and yet permits foreign competitors to take over this international business.

Another example involves technology in less developed areas. If a Brazilian subsidiary of a U.S. corporation uses an exclusive formula to make a product, even though it purchased that formula outright in an arm's length transaction from a U.S. corporation at fair market value and U.S. tax was paid on the gain, any future income from the use of that formula in Brazil will be "Subpart F income" in the United States because the formula was developed or created in the United States.

It is not enough to say that the U.S. tax can be postponed in some cases if the earnings are reinvested in less developed areas. The limitations on these provisions are totally unrealistic and are designed to make reinvestment even in less developed areas almost impossible.

We shall be glade to give examples, Mr. Chairman, in questions and answers.

The provisions of section 13 are further designed to encourage less developed countries to pass laws limiting the percentage of ownership by U.S. interests contrary to the objectives of the Alliance for Progress.

I would like a brief insertion, Mr. Chairman, on section 16 which we did not include in the written text.

SECTION 16—GAINS FROM SALES OR EXCHANGES OF STOCK IN FOREIGN CORPORATIONS SHOULD CONTINUE TO BE TREATED AS CAPITAL GAINS

Section 16 of the bill would have a U.S. taxpayer go all the way back to February 28, 1913, and include proportionately as dividend income so much of the gain on a sale or exchange of foreign corporate

stock as had been earned by that foreign company since February 28, 1913.

Such a penalty provision is not necessary to achieve the objectives of this bill. It would be especially confiscatory in our Latin American areas, where U.S. subsidiaries have reinvested these earnings in additional productive facilities in the less-developed economies now a part of our Alliance for Progress.

If such a provision is to be enacted by the Congress, and we recommend against it, it should be prospective only and apply to earnings after December 31, 1962.

The effective date of this new liquidation, according to H.R. 10650, is to be the effective date of the 1962 Revenue Act. It will be confiscating a part of these earnings and denying U.S. business the opportunity of readjusting their operations and liquidating these foreign investments under the terms of the present law upon which reliance has been placed for more than 48 years.

SECTION 17—COOPERATIVE TAX TREATMENT SHOULD BE REVISED

The chamber has consistently held as a policy declaration that no form of lawful enterprise should be favored over any other form and each, whether corporate, cooperative, or individual should stand on its own merits with protection from unfair competition, but without benefit of tax exemptions or special exemption from legislative restraints, and without any other Government subsidies.

SECTION 19—WITHHOLDING

The chamber is not unmindful of the loss of Government revenue involved in the recommendations presented to the committee in this statement.

It is also mindful of the loss of revenue annually from unreported interest, dividends, and patronage dividends.

To see that each taxpayer pays his fair share of the burden is our objective as well as yours. We, therefore, support the principle of withholding on interest, dividends, and patronage dividends at source.

However, in appraising these provisions of the bill the committee will wish to evaluate such matters as the administrative complexities of a nonreceipt withholding tax system; the cost of administration to the revenue service, to taxpayers and to paying agents; the problems of overwithholding of tax; the changes which must be made in the individual income tax form 1040, and whether now or in the near future the service's automatic data processing installations plus the use of taxpayer account numbers, can be a substitute for the withholding of tax.

SECTION 21—EXISTING TAX TREATIES SHOULD NOT BE OVERRIDDEN

American and foreign businessmen and Government officials were shocked and disturbed by the Ways and Means Committee's press release of February 23, 1962, which stated in part as follows:

> The committee adopted a provision to the effect that in the event of conflict between a provision of the bill and a treaty, the treaty is overridden. (Now sec. 21 of H.R. 10650.)

Europeans are seriously concerned with this type of unilateral abandonment of treaty obligations and wonder whether this will be precedent to be followed in trade agreements in future years.

European competitors of American trading companies are now confident that the new U.S. tax bill will eliminate competition from U.S. companies regardless of the more favorable terms of any new trade agreements.

To this extent, certain foreign income provisions of H.R. 10650 and the trade agreement provisions of H.R. 9900 run in direct contradiction to each other and destroy for U.S. businessmen the possibilities of full and fair competition with foreign corporations.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Kerr?

Senator KERR. In your prepared statement you say that they are further designed to encourage less developed countries to pass laws limiting the percentage of ownership by U.S. interests contrary to the objectives of the Alliance for Progress.

Do you support the program of the Alliance for Progress?

Mr. SLOWINSKI. The chamber does support the program of the Alliance for Progress.

Senator KERR. You talk about the retroactive provisions back to 1913.

Could that not easily be corrected by an amendment in support of the retroactive features concerned?

Mr. SLOWINSKI. Yes, sir, and we are hopeful, as the Secretary of Treasury suggested yesterday, that this committee will take that action.

Senator KERR. You say:

> Europeans are seriously concerned with this type of unilateral abandonment.

Do any of the European or South American countries ever take unilateral action of abandonment of agreements with us?

Mr. SLOWINSKI. Senator, Chairman Mills asked me that question 2 weeks before in the Ways and Means Committee.

Senator KERR. I wasn't there.

Mr. SLOWINSKI. And I said, as the son of an immigrant, I would be hopeful that we in the United States take great pride that we never break our word, as opposed to the nonfree world which does so regularly. To the extent we don't have to break our word by overriding tax treaties, I am hopeful we will find another way.

Senator KERR. I fully understand what you said. Now would you answer my question?

Mr. SLOWINSKI. Have other nations abandoned tax treaties?

Senator KERR. Do they abandon unilaterally either treaties or other agreements with us or commitments to us when their interest indicates that it is profitable for them to do so?

Mr. SLOWINSKI. I assume some have, Senator Kerr.

Senator KERR. You assume they have. You don't know of any instance where they have?

Mr. SLOWINSKI. Not offhand, but there are probably some we can research and find.

Senator KERR. Don't you know as a matter of fact that is the general practice?

Mr. SLOWINSKI. No, sir.

Senator KERR. You wouldn't be surprised, however, to learn that it's not an unusual occurrence.

Mr. SLOWINSKI. As opposed to a general practice, Senator?

Senator KERR. I am speaking now of individually. You wouldn't be surprised to learn that it is not unusual for such an individual incident to occur.

Mr. SLOWINSKI. No, sir; and now that you have mentioned it, I think Cuba is an example.

Senator KERR. What about the act of the Brazilian Government in taking over $15 million worth of property of the International Telephone Co. and offering them $400,000?

Mr. SLOWINSKI. Senator, that wasn't done by the Government of Brazil that was done by the Province of Rio Grande do Sul.

Senator KERR. Does it make it any less painful to I.T. & T.?

Mr. SLOWINSKI. No, sir.

Senator KERR. You understand I am not approving that. I am just asking you if you are aware of it.

Mr. SLOWINSKI. I think the analogy would be if the State of Oklahoma took over the telephone company.

Senator KERR. You think that is likely?

Mr. SLOWINSKI. No, sir. [Laughter.]

Senator KERR. You think any State in the American Union could do that—now listen, if you want to start kidding each other, I am an expert at it.

Mr. SLOWINSKI. No, we are hopeful this never happens.

Senator KERR. Did the Brazilian Government do anything to prevent that act by the Brazilian state?

Mr. SLOWINSKI. No, sir; but it is trying to do something about it now.

Senator KERR. Well, that is interesting news to I.T. & T. I am sure that they will be happy to learn that and the last time I talked to them didn't know it.

Mr. SLOWINSKI. That is right.

Senator KERR. Did Mexico expropriate American property?

Mr. SLOWINSKI. Yes, sir.

Senator KERR. Do you know whether or not a majority, for instance, of the Arabian countries have gradually forced American companies into changing agreements that they had with them to a basis more favorable to these governments than the ones into which they entered?

Mr. SLOWINSKI. Yes, sir.

Senator KERR. Then your use of Cuba as an example was not because you thought that was the only example, but one which you would rather have the attention of the committee directed to as others?

Mr. SLOWINSKI. No, sir. The Arabian negotiations are included in testimony before a congressional committee.

Senator KERR. Well, let's don't refer to things that will make me have to go to work. If you know the answers just give them to me, and if you don't, why, tell me. They have constantly coerced the American companies to change the agreements to more favorable ones for the benefit of the Arabian countries, haven't they?

Mr. SLOWINSKI. Well——

Senator KERR. Just answer that "Yes" or "No." If they haven't why, say so.

Mr. SLOWINSKI. We might not agree with your word "coerce." We think these might be the results of negotiations.

Senator KERR. Well, they brought changes and agreements to the disadvantage of American companies, didn't they?

Mr. SLOWINSKI. Yes, sir.

Senator KERR. To the disadvantage of the American companies?

Mr. SLOWINSKI. Yes, sir.

Senator KERR. You think the American companies did that willingly and freely and of their own accord?

Mr. SLOWINSKI. I have no knowledge.

Senator KERR. Well, if you would have been representing them, would you have done it if you hadn't felt you had to?

Mr. SLOWINSKI. If it were a matter of protecting the interests of the American company to stay there, yes, Senator, I agree. We would probably do it.

Senator KERR. You would have done it under coercion just like they have done it under coercion, wouldn't you? If you do it not of your own free will and accord, it is a result of some kind of pressure, isn't it?

Mr. SLOWINSKI. It could be compromised.

Senator KERR. I say it is the exertion of some kind of pressure, isn't it?

Mr. SLOWINSKI. Yes, sir; some kind of pressure, yes.

Senator KERR. Call it what you will.

Mr. SLOWINSKI. Yes.

Senator KERR. You think we should continue to guide ourselves solely by idealism, and don't misunderstand me, I am highly in favor of the most idealistic approach consistent with our own national security and interest, but you don't think that we should be bound to it inflexibly in a world where as time goes on, it seems more and more that we would be the only one that would be inexorably dedicated to it, do you?

Mr. SLOWINSKI. No, Senator, I agree.

On the tax treaties, frankly, if there were a conflict between a tax treaty and a provision of our code, we could have reopened negotiations to renegotiate those tax treaties just as we are now doing with the Government of the Netherlands during the past week.

We sit down and say we would like certain concessions in the tax treaties. The other government could ask for certain concessions in the tax treaty and we could probably work them out.

Senator KERR. That is all.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Slowinski, it is your position if these tax treaties are to be changed they should be changed by first negotiating with these countries rather than an arbitrary action by the countries?

Mr. SLOWINSKI. Yes, sir.

Senator WILLIAMS. In the first part of your prepared statement, you take exception, as I understand it, to the incentive credit of 8 percent for depreciation. Now do you have any particular formula which you would recommend as a substitute therefor?

Mr. SLOWINSKI. Senator, the chamber has consistently taken a position asking for a basic revision upward of our depreciation rates, and a simplified classification of depreciable facilities in Bulletin F. Now that is only the first step.

Once Bulletin F lives are made realistic—as Secretary of the Treasury indicated, there is more to be done—in the area of liberalizing present provisions of our code, such as sections 167 or 179, without putting an entirely new concept such as the investiment tax credit into our code.

That could be done in perhaps a number of ways, including an increase in certain accelerated methods of depreciation which are now in section 167 of the code. We have in mind, Senator, your triple declining balance recommendation. We think this might be one of the alternatives to be used after realistic depreciable lives have been determined.

Senator WILLIAMS. Then I understand you are recommending that whatever is done toward liberalizing our depreciation rates should be done by liberalizing existing formulas which would in effect be under a system where all taxpayers could readily understand and compute their own tax liability without the necessity of hiring experts to figure out this complicated formula proposed in this bill?

Mr. SLOWINSKI. Yes, sir.

And we are aware of the colloquy yesterday where the Secretary of the Treasury had difficulty telling Senator Douglas which facilities might qualify and which might not qualify as section 38 property, under section 2 of the bill.

Senator WILLIAMS. Thank you.

I have no further questions.

The CHAIRMAN. Senator Morton?

Senator MORTON. Sir, on this matter of taxing these foreign-owned subsidiaries, I see from your statement, and I share your position, that we should do something to take care of the so-called tax haven, third country tax haven operations.

But is it not true that in general in the developed countries of Western Europe, the companies with foreign-owned subsidiaries export from the United States five or six times as much in dollars as their subsidiary companies send back to the United States?

Mr. SLOWINSKI. Senator Morton, that is true, and we would like to include in the record, if we may, a speech, a portion of a speech made by the Secretary of Commerce on March 16, of this past month, March 16, 1962.

Secretary Hodges said this:

While the basic aim of our tax policy is to stimulate domestic growth, we are not unmindful of the problems faced by you as subsidiaries abroad, including the problem of competing with foreign companies subject to different total tax obligations.

U.S. investment abroad is important to our export, expansion program. Direct investments in manufacturing facilities abroad stimulate our exports of capital equipment, our exports of parts and raw materials, and our exports of finished products to fill out the lines of subsidiaries producing and selling abroad. To the extent that the U.S. investment aboard increases the financial strength and the competitive capacity of American companies it reinforces our domestic economy, and to the extent that the earnings on these investments are returned to the United States, they make a direct contribution to improving our balance of payments.

Our overall economic objectives require the continued expansion of U.S. investment to help develop, particularly in the underdeveloped countries, the prosperous customers with whom we expect to expand our trade.

This was the Secretary of Commerce, Mr. Hodges.

Senator MORTON. Then, we establish the fact that on the basis of exports and imports to this country from just those companies that have foreign-owned subsidiaries, that the balance of payments is in our favor by a ratio of some 4 or 6 to 1?

Mr. SLOWINSKI. Senator Morton, I would also like to include the figures which just became available from the U.S. Department of Commerce in March 1962, in the Survey of Current Business.

It shows that the total profit and dividend remittances by foreign subsidiaries to U.S. parent corporations rose 13 percent in 1961, to $2.65 billion, while the total outflow fell off slightly to $1.6 billion, leaving a surplus of $1.05 billion or 63 percent above the 1960 surplus.

The statistics also reveal a sharp increase last year in new investment in underdeveloped countries. The flow of funds more than doubled to Latin America, and almost tripled to what is called the other category by the Department of Commerce, which means areas other than Europe and Canada and Latin America, which means areas such as Africa and southeast Asia.

Again, Europe showed a net deficit down from $544 million to $113 million, which was largely reflected by the absence of the Ford Motor Co. transaction with its British subsidiary.

They also, we think, are significant figures in saying that more profits are coming home now on investments which are beginning to mature, having been made in the postwar era when we were interested in assisting Europe in regaining its economic feet.

Senator MORTON. Well, you have anticipated my next question and already answered it. But back to my first point. The amount of dollars of exports from this country, where American domestic jobs are involved, to foreign subsidiaries are about five times as much as imports to this country from these same subsidiaries.

That in itself helps our balance of payments, is that not true?

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. The point you just made is in the matter of investments in dollars abroad related to the return on that investment and previous investments abroad, and you have quoted the figures that have just become available for 1961 and they are most encouraging and show a very favorable balance of payments there.

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. Is it not true that from 1950 to 1960 we saw a terrific expansion in American investments abroad, in developed as well as some underdeveloped countries, that was a decade of expanded investments abroad, wasn't it?

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. Is it not true also in that decade we returned in profits after all the abuses that may have developed in the tax haven countries some $8 billion more than we invested in total dollars abroad in this decade?

Mr. SLOWINSKI. That is true.

Senator MORTON. $20 billion was returned in profits on which taxes were paid here. Therefore, both from actual export-import balance

and from earnings recovered from our foreign subsidiaries in excess of foreign investment there is a substantial contribution to a favorable balance of payments and that these two items are not responsible for the balance-of-payment difficulty in which we find ourselves today.

Mr. SLOWINSKI. Senator, those figures are going to get better.

The Common Market, a dream and now as a reality, is only 4 years old. People who invested in those areas of the world are just beginning to realize profits from the amounts invested after repayments of the loans which foreign governments in some cases granted to build those facilities there.

Senator MORTON. Is it not your opinion that the vast majority of American investments abroad in subsidiary plants is motivated by the profit system—they go over there to make a profit.

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. Under our system that is axiomatic.

Now, aren't most of them over there to hold their business in the country in which they invest or to hold their business in other foreign markets?

In other words, an American company puts a plant in France, not only to hold its business in France and to expand its business in France, but to hold its business, let us say, in Italy or in Africa or in the Middle East or somewhere else, which a French company has been taking from the American parent company for one reason or another.

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. And the motivation to go abroad to build a plant to just hold a diminishing American market against competing imports is relatively minor, and that segment is relatively minor in this whole scheme of things.

Mr. SLOWINSKI. Yes, sir.

Senator MORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Mr. Slowinski, I invite your attention to the statement where you speak of deductions for legislative activities or lobbying and I would like to ask you this question:

Under section 3 of the bill as it is now before us, if I am president of a racing corporation which wants to establish a racetrack in a given State, and in order to do so must obtain legislative permission, can I lobby for the passage of this bill before a legislative committee or administrative authorities and deduct those expenses as tax exempt under the bill as it now reads.

Mr. SLOWINSKI. Senator, I think so.

On page 26 of the bill, at the section at line 11 that says,

> In direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and of such organization.

Senator DOUGLAS. Well, that would be communications which I might address to the stockholders in my corporation.

But section (a) above is even more explicit, is it not? It—

> permits deductions in direct connection with appearances before and submission of statements to or sending communications to the committees or individual Members of Congress or of any legislative body of a State.

Mr. SLOWINSKI. Yes, that is right.

Senator DOUGLAS. This would be tax deductible.

Now, let me raise a question. Suppose you, Mr. Slowinski, are a minister and representing a point of view at the racetrack is not his trade or business in a State in which I want to establish a racetrack and you feel that the establishment of this racetrack would be injurious to the public welfare in that it would encourage gambling and concentrate people's attention upon chance rather than upon effort as a means of getting ahead in life and you feel that you should appear before the State legislature to lobby against my bill to establish a racetrack.

Could you as a minister of the Gospel deduct your expenses in connection with appearing before the legislature as tax deductible?

Mr. SLOWINSKI. Senator, if this is of direct interest to the minister, and I assume it is——

Senator DOUGLAS. Well, it is not of direct economic interest, it is only of moral interest.

Mr. SLOWINSKI. That is right.

Mr. and Mrs. Cammarano wanted to save their wholesale beer distributing business in Seattle, and they were told that spending money to go to the legislature to try to save their beer business was not deductible.

Senator DOUGLAS. The minister is not in the beer business. He is a minister of the Gospel.

Mr. SLOWINSKI. That is right.

Senator DOUGLAS. And my question is if trying to protect the morals of the community as he sees them, he goes before a State legislature, and incurs expenses, and, let us say, eats a meal costing 75 cents, and has a hotel room that costs $6, can he deduct that from his taxable income?

Mr. SLOWINSKI. I would be hopeful he could, Senator.

Senator DOUGLAS. Well, you would be hopeful that he could; but is there anything in the law which would permit him to do so?

Mr. SLOWINSKI. Not presently; no, sir.

Senator DOUGLAS. Not presently?

Mr. SLOWINSKI. That is right.

Senator DOUGLAS. Then the law as it is at present would permit the president of a racetrack corporation to deduct his expenses, directly lobbying outlays for the racetrack but would not permit the minister of the Gospel from making a deduction of his lobbying expenses against it.

In other words, if you want to get something through which will benefit you financially, you can deduct this, and if you are a corporation, say, you can have 52 percent of the bill met by the public; isn't that true?

So the minister would be taxed, as a matter of fact, taxed more heavily than the representative of the racetrack who appears; is that true?

Mr. SLOWINSKI. Senator, the Congressional Record has contained some articles called "Censorship by taxation," which refer to just that question.

The right to petition Congress should be granted everyone in terms of his direct interest in the legislation.

Senator DOUGLAS. Would you say you were in favor of broadening this act so that any expenditure by an individual either for or against the bill would be tax deductible?

Mr. SLOWINSKI. No, sir; I would think——

Senator DOUGLAS. You would or would not?

Mr. SLOWINSKI. No; I would be in favor of classifying the term "direct interest" to have a more general application that would include your minister.

Senator DOUGLAS. How would you define it?

Mr. SLOWINSKI. The revenue agent defines it every day in terms of——

Senator DOUGLAS. Thus far they have defined it so that the minister would not be able to deduct his lobbying expenses, but the company would, the racetrack company would.

Mr. SLOWINSKI. Section 4 of the bill is going to define direct interest in terms of when you take someone to lunch, whether or not this is a direct interest or business connection.

I would be hopeful we could move some of that into section 3.

Senator DOUGLAS. This is very interesting.

Senator KERR. Senator, would you yield for just an observation?

Senator DOUGLAS. I will yield, if you are my ally on this.

If, on the other hand, you are not my ally I will not yield. [Laughter.]

Senator GORE. Declare your position, sir.

Senator KERR. I was going to speak from an objective neutral position.

Senator DOUGLAS. You always add to the gaiety of a session, Robert.

Senator KERR. I appreciate that.

I was just thinking about the minister and I want to say that I think the Senator has a valid point, but in view of the fact that the minister would be sent there by, I presume, his congregation, whose income is tax free they could pay his expenses but if he found a place here where he could get a meal for 75 cents and a room for $6 a day, he could establish a travel bureau and make that a very profitable business.

Senator DOUGLAS. Now, suppose the minister came not in obedience to any resolution by his congregation but according to the mandates of his conscience which should be the most powerful mandate of all.

Mr. SLOWINSKI. Senator, that very question under the present law troubles crime commissions and you know about crime commissions in your own jurisdiction. Crime commissions cannot spend money to appear before legislative bodies under threat of losing their income tax exemptions.

Senator DOUGLAS. Yes.

Mr. SLOWINSKI. And we now feel if section 3 is broadened, that both the minister and the crime commission can participate.

Senator DOUGLAS. Would a minister be entitled to deduct his travel expenses in appearing before——

Mr. SLOWINSKI. We would like to see it that way.

Senator DOUGLAS. You would?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Ministers are not the only people in the country authorized to have consciences.

[Laughter.]

Senator DOUGLAS. Suppose a private citizen feels a conscientious objection to a racetrack. Should he be permitted to deduct his expenses?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. What?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Yes, the answer is "Yes"?

Mr. SLOWINSKI. Yes.

Senator DOUGLAS. All right.

You want to broaden this exemption still further to include not only the cost of direct appearances, but advertising and other propaganda in connection with the measure?

Mr. SLOWINSKI. We want to exclude anything which has to do with a political campaign.

Senator DOUGLAS. I understand.

But full-page ads in newspapers on a given matter for a racetrack, for instance, would still be deductible.

Look at your own language.

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. It would be deductible, would it not?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Now, suppose a group of private citizens wants to place an ad in opposed to the racetrack, should that be deductible?

Mr. SLOWINSKI. Yes.

Senator DOUGLAS. Suppose the president of an oil company wants to carry on extensive advertising campaign to protect the depletion allowance and to get higher gas rates should that be deductible?

Senator KERR. Oh, yes. [Laughter.]

I hope I speak as an ally. [Laughter.]

Senator DOUGLAS. I am afraid you don't Bob.

Mr. SLOWINSKI. Would you like the record to show my saying yes or the Senator saying yes?

Senator DOUGLAS. I would like to have the record show your position.

Mr. SLOWINSKI. Yes.

Senator DOUGLAS. That means in effect, does it not, that the taxpayers would finance 52 percent of the expenditure?

Mr. SLOWINSKI. Yes.

Senator DOUGLAS. Yes.

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Would you favor private individuals having this same right to deduct contributions?

Suppose Senator Gore and I pass the hat and get money for ads against the 27½ percent depletion allowance, should we be permitted to deduct that from our income and make it nontaxable?

Mr. SLOWINSKI. Should the people who give you the money in the hat be allowed to deduct it?

Senator DOUGLAS. Yes, and such contributions as we may make, should that be deductible?

Mr. SLOWINSKI. Yes.

Senator DOUGLAS. You haven't answered. You have nodded your head.

Mr. SLOWINSKI. Yes, sir.

To do otherwise, Senator, would be to say we do have censorship by taxation.

Senator DOUGLAS. Not censorship but unfair advantage.

Mr. SLOWINSKI. Yes; namely, a wealthy man can come before the Congress because he can spend money and he doesn't need a deduction. A poor person who needs the deduction loses his right to come before this Congress because he can't afford it without a deduction.

Senator GORE. The poor man is not involved in this. Let's leave them out.

Mr. SLOWINSKI. Senator, Mr. and Mrs. Cammarano were not wealthy people.

Senator DOUGLAS. This is very interesting. I didn't think you would have the consumers taking advantage of this opportunity which you have so generously accorded to the same degree that you would have a corporation with public relations experts and with access to advertising firms and with ample funds which they could use in this fashion——

Mr. SLOWINSKI. It boils down to the question——

Senator DOUGLAS. You know the famous quotation of Anatole France in which he said the majestic equality of the law forbids the rich as well as the poor from sleeping under bridges and begging in the streets for bread. [Laughter.]

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. May I ask you to turn to section 4.

Senator GORE. Senator Kerr looks as though he may be shifting into neutral gear again.

Senator KERR. I became an ally again.

Senator DOUGLAS. If you will look at section 4, Mr. Slowinski.

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. The records of the Tax Court show there was a man who bought a yacht for $251,000 and claimed it was an entertainment expense. The Tax Court allowed this on the ground that he was using it to entertain guests who might be of some conceivable importance to him as customers and under the Cohan rule they felt themselves, therefore, obliged to regard this as tax deductible.

Do you approve of this ruling?

Mr. SLOWINSKI. No, sir.

Senator DOUGLAS. You do not?

Mr. SLOWINSKI. No, sir.

Senator DOUGLAS. How would you suggest——

Mr. SLOWINSKI. This is in addition to the *Safari* case that you know of, involving the milk distributor who went on safari and came back and claimed the safari expenses deductible because the pictures of the animals on the milk trucks made children drink more milk.

We think that a vigorous enforcement of the law as it presently stands will take care of the yacht case, Senator. The revenue agent has a right to come on board that vessel and get the log of that yacht for the entire taxable year, to ask who came on board on what days, and what were they doing there, and then he has the right to require the taxpayer to relate those guests to actual business obtained.

If the agent doesn't do this, then he hasn't vigorously enforced the law.

Senator DOUGLAS. How many agents would be required to do that?

You would have to have as many agents in the Fort Lauderdale harbor as you have college boys and college girls on Easter vacation there. [Laughter.]

Mr. SLOWINSKI. Passing a new law will not decrease the administrative burden of audit. A doctor here in this city sends flowers to his patients and to his prospective patients. The revenue agent may say: "You can't deduct these flower costs until you show me that these people are patients or a good portion of them have come to you as patients." The doctor is obliged to list the people to whom he sent these flowers and the patients which resulted.

This is under present law.

Senator DOUGLAS. You think that it would be all right, though, this $251,000 yacht, if it had some business guests on board, there would be a proper deduction?

Mr. SLOWINSKI. No, sir; it should be a business——

Senator DOUGLAS. How many business guests?

Mr. SLOWINSKI. The latest case involved an accountant who flew a pennant on his yacht saying "1040" so that he showed everyone at the yacht club he was a tax accountant and thereby he was attracting tax business. The Tax Court said, "No reduction for yacht expenses."

Senator DOUGLAS. Well, in this particular case that I cite the Tax Court said that it was a deduction and I may say here was a case in which the internal revenue agents prosecuted the case very vigorously and were turned down under existing law.

Don't you think the law needs to be tightened on this point?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. There is another case of a man who was in business who spent, I believe, $27,000 for entertainment on board a yacht, and he was brought up before the Tax Court and he said that it was a business expense to entertain future customers, and he was asked what his business was and he said, "I am a mortician."

Now, that presents a somewhat ghoulish idea, of inviting prospective customers of an undertaker in order to attract their business, but he got by with it.

What would you think of that, and the court upheld him.

Mr. SLOWINSKI. It should not be tolerated.

Senator DOUGLAS. It should not be tolerated?

Mr. SLOWINSKI. No, sir.

Senator GORE. How does that differ from the surgeon sending flowers to his prospective customers?

Mr. SLOWINSKI. The surgeon was able to show that he actually had these patients as the result of this constant attention.

Senator KERR. Maybe the undertaker could have shown the same thing.

Mr. SLOWINSKI. Senator, undertakers spend a great deal of money frankly keeping in touch with families. [Laughter.]

This is as ghoulish as you say it is, but this is a fact in business life.

An undertaker who became an introvert and failed to advertise and failed to belong to all of the fraternal organizations and have his wife belong to all the women's organizations would soon find the volume of his business falling off.

Senator DOUGLAS. It should be tax deductible if he belongs to the Elks Club in order to be able to bury the Elks. This ought to be tax deductible.

Mr. SLOWINSKI. This is as much deductible as the undertaker's ads we see in the D.C. Transit buses, perhaps more so because it is more personal.

Senator DOUGLAS. Now, I have known corporate executives who have hunting lodges in the Canadian wilds, fishing shacks, elaborate fishing shacks, on well-stocked rivers some of whom have occupied leading positions in the U.S. Government. And at present their outlays are generally regarded as tax deductible. Do you approve of that?

Mr. SLOWINSKI. No, sir, and the administrative weapon against that practice is to include in that corporate executive's income the full fair market value of all of the pleasure he receives from that fishing lodge, stating in effect, "This is additional income to you, Mr. Executive, because you have enjoyed it in addition to your salary."

Senator DOUGLAS. Have you read the *Cohan* decision?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Well, in the *Cohan* decision any objective chance is virtually thrown away.

Mr. SLOWINSKI. The *Cohan* decision is useful for revenue agents. When a man can prove to a revenue agent, for example, that he went to Chicago on business but he did not retain his train ticket and he can prove that he stayed in the Palmer House with a room costing $14, but he did not retain the hotel bill, and that he spent a hundred dollars in travel to Chicago and back, the *Cohan* rule is important if he can show that he made the trip or give the agent——

Senator DOUGLAS. I am not talking about a hundred dollar trip to Chicago. I am talking about deductions of $20,000, $40,000, $50,000, $250,000 for yachts, and so forth which have been upheld under the *Cohan* rule.

Mr. SLOWINSKI. They have not been tested, however, under the reasonable salary rule, Senator, which I am saying is another administrative avenue.

Senator DOUGLAS. Don't you think that some of these abuses on entertainment should be plugged?

Mr. SLOWINSKI. I think they are shocking and should be plugged.

Senator DOUGLAS. Instead of taking this attitude of opposition I hope we can work together constructively because I think it gives a black eye both to business and tends to break down the tax structure.

Mr. SLOWINSKI. Senator, our statement mentioned being considerate of the "average" businessman in two cases because we feel the Revenue Service should be able to catch the large tax avoiders.

Senator DOUGLAS. Not the average——

Mr. SLOWINSKI. That is right.

Senator DOUGLAS. But the violators of the spirit?

Mr. SLOWINSKI. We agree.

Senator DOUGLAS. Just one final question I would like to ask. I read into the record yesterday part of a statement which appeared in the New York Times on pages 33 and 45.

Do you remember that describing Manuscripts, Inc.?

Mr. SLOWINSKI. Yes, sir; I heard your statement yesterday.

Senator DOUGLAS. Apparently it is possible for movie actors, movie producers, authors, and so forth, to go abroad, live there for 17 months and through various corporate devices, probably involving the creation of a foreign corporation, be paid to live in a country which has almost no income tax itself, and then they are exempt from all taxation by the United States, and here is a group which made a bid to authors to do this. They have stated they signed up an author who sometimes has been critical of Congressmen for having too high travel expenses.

Don't you think there should be some protection on this income earned abroad of earnings?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Earnings earned abroad?

Mr. SLOWINSKI. Yes, sir.

In 1953, while the Congress was working on the 1954 code a movie actor came home and stood on the deck of a ship in New York harbor and stated publicly that he had made several movies in Europe and, therefore, all his money was earned abroad and would not be taxable in the United States.

Senator DOUGLAS. I commend him for his frankness.

Mr. SLOWINSKI. Well, what he did then was to injure every legitimate technician and engineer who went abroad as a U.S. citizen to work in a developed or less developed country because the temper of the Ways and Means Committee at that time became inclined to remove section 911 (a) and (b). Mr. Reed was chairman and he indicated the committee would remove these sections.

Here is an abuse which, typically as an abuse, prompts the Congress to take an otherwise good provision out of the law.

Senator DOUGLAS. Apparently, there are still loopholes because we have Manuscripts, Inc., advertising for authors whom they would put on salary, send abroad, send to some place such as Switzerland and Lichtenstein or they might send them down to enjoy the pleasures of Nassau, and be tax exempt there and be tax exempt here.

Shouldn't we try to plug that loophole?

Mr. SLOWINSKI. We certainly should.

Can you tell me whether that was a U.S. corporation? Is Manuscripts, Inc., a U.S. corporation? We have several alternatives.

Senator DOUGLAS. It says a small New York corporation.

Mr. SLOWINSKI. If it is a New York corporation two things can happen.

One thing is the U.S. Treasury Department can deny to that U.S. corporation a deduction of any portion of that salary which it feels is unreasonable salary to these writers who are living abroad.

Senator DOUGLAS. Unreasonable? What is unreasonable?

He is paid out of expected royalties, and these authors can earn the money, it belongs to them. The question is whether they should evade taxation upon it. And I merely cite this as an illustration, because apparently this is done by movie actors and producers to a very large amount.

Mr. SLOWINSKI. This is the type of case which reacts unfavorably on legitimate U.S. citizens working abroad.

Senator DOUGLAS. Shouldn't we try to protect ourselves?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Well, now——

Mr. SLOWINSKI. But still leave open the door for legitimate operations abroad.

Senator DOUGLAS. You say the foreign income provisions of section 13 should be eliminated. You are out to sweep section 13 away almost completely?

Mr. SLOWINSKI. Section 13 should be eliminated because section 13 is in that bill to discourage any legitimate U.S. corporation from going abroad or staying abroad.

Senator DOUGLAS. Well now, as one who has traveled abroad and lived abroad some, I think it is a very fascinating experience to live abroad. I would not discourage authors from going abroad, I think it helps the art critics very much to see museums in Europe and so on.

I regard the trade of writing and movie producing just as legitimate as producing oil or chewing gum, possibly a bit more so, but certainly no less.

Now——

Mr. SLOWINSKI. Senator, I am sorry, I thought you were referring to section 13 of the bill which treats controlled foreign corporations we are referring to section 12——

Senator DOUGLAS. You can set up these corporations. I simply say the people would be able to go establish residence in a tax haven and we developed yesterday some of these tax havens, I am not certain we have got them all, and Switzerland was one of the most notorious tax havens in Europe, not only in the Federal Government but in the cantons. Lichtenstein, no income tax; Panama, the Bahamas, there are probably others and these are merely illustrations.

Mr. SLOWINSKI. Senator, may I speak for a few minutes——

Senator DOUGLAS. I don't know about Monaco.

Mr. SLOWINSKI. May I speak for a few minutes on why these countries arrived at those tax rates which you discussed yesterday?

Senator DOUGLAS. Surely.

Mr. SLOWINSKI. There are several basic theories of tax jurisdiction. All of these appear in a text by Bittker and Ebb on "Taxation of Foreign Income," which is a collection of cases and materials which has just recently been prepared as well as in other mimeographed materials in a Harvard seminar called Legal Problems of Doing Business Abroad.

Senator DOUGLAS. May I say when I have time I will consult that?

Mr. SLOWINSKI. I just wanted to give a source for my data. The United States began in 1913 and through 1918 and 1921 deciding what our theory of tax jurisdiction would be in the United States.

In section 11 our Congress said all corporations shall be subject to a corporate income tax, all corporations. This meant domestic and foreign.

In what is now section 11(d) Congress then said that foreign corporations not engaged in trade or business in the United States shall not be subject to an income tax. So our test in the United States is nationality or residence.

If a company is a U.S. corporation it is taxable on its worldwide income. If the company is resident here in the United States it is taxable on its U.S. source income.

The United Kingdom, Canada, and Australia do not use this as their tax jurisdiction test at all.

Their test is "management or control" or "seat of management." If a Tanganyikan company is managed and controlled in the United Kingdom, it is taxable as any United Kingdom company.

The Spanish civil law concept of taxability is territorial.

Venezuela feels that if a dollar is earned in Venezuela it will be taxable in Venezuela. If a dollar is earned by a Venezuelan company in Brazil it will not be taxable in Venezuela because it was not earned in Venezuela. But by the same token, a dollar spent, if it is spent in Venezuela for ordinary and necessary business expense, will be allowed as a deduction, but if it is not spent in Venezuela, there will be no deduction.

Now, in Western Europe each of the countries has borrowed from the civil law concept of taxation. Belgium has a 40 percent corporate rate but if a Belgian corporation earns income outside Belgium—this is to encourage Belgian corporations to go outside and do business—the income tax on that foreign earned income is reduced to 12 percent.

French tax law provides that if a French corporation (where the corporate income tax rate is 50 percent) goes outside France and earns income when that income comes back in the form of dividends, it shall generally be subject to tax not at 50 percent but at 24 percent, plus the corporate rate of 50 percent on one quarter of the dividends. This amounts to about a 33.5 percent tax rate as opposed to 50.

The Netherlands since 1892 has had a theory of tax jurisdiction which provides that if a Dutch company places a permanent establishment in another country where there is an income tax system like the Dutch income tax system, not the same 47 percent rate, the profits of that Dutch permanent establishment in another country can be brought back to the Netherlands tax free.

The United Kingdom in 1957 passed the Overseas Trade Corporation Act (which it will now probably renew during the month of April). An overseas trade corporation does all of its business outside the United Kingdom, just as proposed under the Boggs bill (H.R. 5) a few years ago, and none of its profits will be taxable in the United Kingdom until they are actually brought home. The foreign exchange policy in the United Kingdom mentioned by Senator Dillon is not new. It has been the law for 10 years—since 1952.

Under H.R. 10650, we now will be the first major country in the world which attempts to tax foreign corporations on earned income before it is returned to its shareholders.

Senator DOUGLAS. This is a very learned discussion, I have not been in the principality of Lichtenstein but some of my friends have been, and they report to me that Lichtenstein is the nominal seat of a whole series of corporations.

These corporations, in effect, spin off income from other corporations in the form of suppositious managerial and accounting fees and so forth. This income is in some cases distributed as salaries.

To the degree that it is distributed as salaries this is exempt from taxation in Lichtenstein and exempt from taxation in the United States, and what you are saying is since Belgium has given the advantages of the Lichtenstein-Swiss tax havens to its corporations we must do likewise.

Mr. SLOWINSKI. No, sir.

We are saying that if that Lichtenstein Anstalt, which is a corporation vehicle——

Senator DOUGLAS. Excuse me, my German pronunciation is not as good as yours.

Mr. SLOWINSKI. If the Lichtenstein Anstalt is a paper corporation the Commissioner of Internal Revenue in the United States can allocate all the income of that company back to the American parent under section 482 and it is the taxpayer's responsibility to show that this income should not be rolled back.

Senator DOUGLAS. Are you acquainted with the domestic laws of the principality of Lichtenstein—are you?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Do you know they have a domestic espionage law which forbids inquiry into the activities of firms in that principality?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Well, how could tax agents find out that? Do you know about the control of the numbered accounts in Swiss banks to which absolutely no publicity can be given. No one can find out whose account it is or who really has these sums. Isn't that true?

Mr. SLOWINSKI. Senator, I would like to answer that by saying——

Senator DOUGLAS. I don't want to be like Senator Kerr in this respect, but I would like a yes or no answer.

Mr. SLOWINSKI. To the extent there is a violation of U.S. law this is true.

Senator DOUGLAS. And Lichtenstein prohibits any inquiry into the affairs of the corporations inside that magnificient principality of some 16,000 people which supports one of the best art galleries in the world in Vienna.

Mr. SLOWINSKI. Senator, the tax returns which are now required under section 6038 which this committee considered late in 1960, will now make it mandatory that every U.S. corporation with any subsidiaries or sub-subsidiaries present this information annually to the Internal Revenue Service and to the extent it does not do so it will be in violation of U.S. law, and face fine and imprisonment. Section 6038 and the other provisions of the law state this clearly.

Senator DOUGLAS. The Senator from Tennessee was the author of that law.

Mr. SLOWINSKI. I think it is a very good law, Senator, and we are this year beginning to comply because it was effective, as you know, for 1962 and later years. The information which will be available to the Commissioner of Internal Revenue will be most helpful.

Senator DOUGLAS. Yes, but the earnings paid by those corporations or subsidiaries will not be taxable in Lichtenstein and will not be taxable in the United States unless the law is changed. The Senator from Tennessee is getting the information, but the tax laws do not permit the tax.

Mr. SLOWINSKI. Senator, may I read you the information now required by law in terms of——

Senator DOUGLAS. I am ready to take your word for it.

Mr. SLOWINSKI. Thank you.

Senator DOUGLAS. But I want to know after you get the information shouldn't somehow that income be taxed?

Mr. SLOWINSKI. Yes, sir.

Senator DOUGLAS. Then help us do it.

Don't object in this fashion.

Mr. SLOWINSKI. We are helping you do it, Senator, to the extent you have section 6 of this bill on a new section 482(b) you have gotten no objection from the U.S. Chamber.

We are in favor of improving section 482 which allows the Commissioner of Internal Revenue to allocate this income between controlled taxpayers to clearly reflect income of each.

Senator DOUGLAS. How can he decide?

Here you have these mysterious corporations which are shielded from inspection, which make charges upon parent companies for managerial and accounting services, and I have talked with some of the people who have these subsidiaries and they frankly admit that the subsidiaries overcharge and that they use this as a device of spinning off income which is not to be taxed.

Mr. SLOWINSKI. To the extent that any business does this, Senator, it is in violation of present law. To the extent that legitimate business does not do it, it should be protected by this 1962 Revenue Act.

Section 13 does not only apply to Lichtensteinian or other tax haven companies. It applies also to all legitimate corporations doing business anywhere in the world.

Senator DOUGLAS. Lichtenstein is merely a symbol of what has developed as a very extensive abuse. It is not only Lichtenstein, but it is also the Bahamas. I talk about Monaco. Don't they have exemption, local exemption, of taxes?

Mr. SLOWINSKI. Likewise.

Senator DOUGLAS. Yes.

And Monaco is supposed to be a very interesting place. I have never been there and I am told there is a very interesting entertainment in the evening. You can look at the great American actress who is the Princess of Monaco.

Mr. SLOWINSKI. Senator, to the extent that present laws apply and are enforced, all of those tax havens can be abolished.

In addition the Commissioner of Internal Revenue should now have section 6 of the present bill with which we agree. All of the income of a tax haven can then be allocated by the Commissioner back to the U.S. company and the burden is on the taxpayer to prove it should not be.

This is the way section 482 currently operates. Also, to the extent that anyone doesn't file the information requested in Senator Gore's section 6038, he is in violation of U.S. law.

No additional legislation is going to put an end to a violation of present law, or a failure to submit information required by law.

Senator DOUGLAS. What you are saying is the foreign countries permit the use of taxation to provide for tax exempt income, and that, therefore, we must do that if our corporations abroad are to compete on equal terms?

Mr. SLOWINSKI. No, sir.

Senator DOUGLAS. That's the only way I can read your statement.

Mr. SLOWINSKI. The U.S. Chamber came before this committee a year ago and asked for support for H.R. 5. H.R. 5 would have provided that if a U.S. corporation goes abroad and does business outside the United States, just as the United Kingdom Overseas Trade Corp., and reports back currently just as any other U.S. corporation, it would be allowed to defer the payment of the U.S. tax on those earnings until it actually brought those earnings home.

Senator DOUGLAS. Well, at the moment I am speaking of the payment of salaries to officials nominally connected with some spin-off subsidiaries in tax-free havens.

Mr. SLOWINSKI. I don't think section 13 addresses itself to that, Senator.

Senator DOUGLAS. Well, there are other sections which do.

Mr. SLOWINSKI. It is illegal to pay fictitious salaries and illegality cannot be cured by more law. If it is illegal now, it is enough law. We feel legitimate business abroad must be given a chance to continue to compete abroad without additional unfair restrictions.

Senator DOUGLAS. Now, this is a very important public policy point which the Senator from Tennessee raised yesterday which he can stress probably more accurately than I can.

It is this: If a foreign government permits an injustice to be practiced so far as its own nationals are concerned, does it follow that we must permit a similar injustice to be practiced by our nationals?

In other words, do we say that we will go down to the ethical level of the lowest ethical level of a foreign government?

Mr. SLOWINSKI. No, sir.

Senator DOUGLAS. And I am not—I am not an xenophobist, I may say, but you certainly have in the case of Lichtenstein and Switzerland and the Bahamas and, I believe, the Channel Islands, and possibly peculiar treaty status of the Virgin Islands, some pretty bad performances.

Now, and Belgium and France, as you say, favor this.

Are we compelled to favor this because the other countries do?

Mr. SLOWINSKI. Senator, we have no sympathy for the tax-haven countries you have mentioned and the operations possible there. We say that with your new section 6 of the bill, you are going to be able to eliminate those countries as tax havens.

However, we also say that with due regard to American industry, if a Belgian company can buy in Luxembourg or the Netherlands and sell into the United States and pay no U.S. tax, but only a 12-percent Belgian tax, the U.S. company which competes with it pays a 52-percent tax doing the very same thing, and it cannot long stay in competition with that Belgian corporation which can ship into the United States under the very same conditions.

Senator DOUGLAS. Mr. Chairman, I will not take up any more time.

The CHAIRMAN. Senator Gore.

Senator GORE. I would like to ask you, with respect to the last sentence you uttered, what tax would be applied to a subsidiary of a U.S. corporation with respect to its business in competition with the Belgian corporation which you cited.

Mr. SLOWINSKI. The U.S. corporate tax of 52 percent would be applied against all the profits of that U.S. trading company.

Senator GORE. If the tax applies only to the profits then there would be no tax unless the company competed successfully, would there?

Mr. SLOWINSKI. Yes, sir; and the Belgian company could replenish its inventories four times faster than the U.S. company.

Senator GORE. So could I in my business in the United States. This comes to a very critical point.

Mr. SLOWINSKI. That is right; full competition.

Senator GORE. This point that so many people make that the U.S. business can't compete if it is required to pay taxes has equal application to U.S. business within our country as well as to U.S. business without our country.

Unless businesses compete and compete successfully, then no income tax liability will accrue.

Mr. SLOWINSKI. Senator, if any——

Senator GORE. Excuse me; so what you are really saying is that they shouldn't be taxed because it prevents them from building up and retaining their profits.

Mr. SLOWINSKI. Not at all.

Senator GORE. Retaining their profits and building up their equities?

Mr. SLOWINSKI. Not at all, Senator.

I am saying that that U.S. company's foreign subsidiary ought to be allowed to compete with that Belgian company at the 12-percent tax rate if it makes a profit and then when the foreign subsidiary declares that dividend to its stockholders (if it has U.S. corporate stockholders) they pay the 52-percent U.S. tax less a foreign tax credit.

Senator GORE. You have leaped completely over the point.

Unless the foreign subsidiary competes and competes successfully, there is no income tax liability, is there?

Mr. SLOWINSKI. No tax liability for either the Belgian company or the U.S. company.

Senator GORE. Well, let's talk now about the U.S. company; we are not talking about the Belgian for the moment. You threw that in.

There is no tax liability on the U.S. corporation unless it earns net profits as a result of successful competition?

Mr. SLOWINSKI. That is correct.

Senator GORE. Then the application of the tax on the profits earned from successful competition does not prevent the company from competing and competing successfully.

Mr. SLOWINSKI. Senator——

Senator GORE. What is sought here is merely to require the payment of a tax on the profits earned from successful competition.

Mr. SLOWINSKI. Senator, at the end of the first year that Belgian company, if it made a hundred dollars will pay $12 in Belgian tax and have $88 to put back in inventory.

The U.S. company will have only $48 to put back into inventory and will not last long as a trading competitor.

Senator GORE. I understand.

So, you are saying once again, as so many have said, that the United States shouldn't require its corporations doing business abroad to pay taxes the same as U.S. corporations doing business at home on the ground that the foreign subsidiary will build up its profits, build up its assets, quicker if the United States declines to levy a tax.

Mr. SLOWINSKI. Not at all.

Senator GORE. We can do the same things to a U.S. corporation in Delaware, Tennessee, or Illinois.

Mr. SLOWINSKI. Senator, I am not saying that at all. I am saying the U.S. corporation which is going to pay that 52-percent U.S. tax in addition to the 12-percent Belgian tax and perhaps it is going to get a foreign tax credit when it pays this 52 percent at home and perhaps not.

There is a tax in Belgium, for example, which is called taxe mobilière which, although it is an income tax, isn't creditable against the U.S. 52-percent tax.

Senator GORE. All right.

Now, why are you saying that it would be bad public policy for the U.S. corporation to pay the same taxes on its earnings abroad on an annual basis as would be the case on its operations domestically.

Mr. SLOWINSKI. I would be glad to give an example in answer to that.

Senator GORE. Tell me why. Why are you saying that now?

Mr. SLOWINSKI. Because the U.S. corporation has an obligation to pay its 52-percent corporate tax in the United States just as any other U.S. corporation but it has that obligation when its subsidiary declares those earnings and profits back to the U.S. parent. If it is a foreign subsidiary of a U.S. corporation under the law, which has been the law since 1918, a foreign corporation, a Belgian corporation, a foreign subsidiary of a U.S. corporation, not resident in the United States, not engaged in trade or business in the United States, does not have its earnings taxable in the United States until it declares those earnings to its U.S. shareholders.

Senator GORE. You mean under present law?

Mr. SLOWINSKI. Under present law, and it has been the law since 1918.

Senator GORE. Let's come to the point.

Just what is the reason, then, that you say the U.S. corporation should not be required to pay taxes annually on its profits earned abroad, the same as on its profits earned domestically.

Mr. SLOWINSKI. This isn't a U.S. corporation, Senator. This is a Belgian subsidiary of a U.S. corporation. This is a corporation incorporated under the laws of Belgium.

Senator GORE. Let's not shift gears quite so rapidly.

The point you were making, and which I was trying to clarify, was that the payment of this tax would prevent this subsidiary from competing successfully with its Belgian or other foreign corporate counterpart?

Senator GORE. And the reason is the foreign subsidiary could not accumulate capital as rapidly because part of its profits would be subject to taxation.

Mr. SLOWINSKI. And over a period, Senator, of 8 years, the foreign corporation would be more than 100 percent ahead of the U.S. corporation.

Senator GORE. I understand that is your point and that is what I was trying to illustrate.

Therefore, there should be no taxes levied at all.

Mr. SLOWINSKI. I don't——

Senator GORE. They would grow much faster.
Mr. SLOWINSKI. I don't think that follows, Senator.
We should pay the tax; we should pay the tax as it is due in any country in the world in which we operate.
Senator GORE. Then I shall seek by this bill to make the due date annually.
Mr. SLOWINSKI. Yes, sir.
Senator GORE. And if it is good to permit capital formation by tax deferment then we could have some bonanzas here at home, too.
Mr. SLOWINSKI. Not if U.S. corporations are forced by competition to withdraw from foreign markets shall we have a prosperous economy here. We can't move to isolationism and still say we are a great country.
Senator Gore, I have a little clipping here that appeared in the financial pages last night in reference to your comment yesterday about the image of the great U.S. industry.
It appeared in last night's Star and it involved Fiat and Volkswagen now fighting to become the largest automobile manufacturer in Europe. It said Fiat intends to acquire 56 percent of Citroen, a large French automobile manufacturer, and this will put Fiat in a principal position because Citroen owns Simca, which is 25 percent owned by Chrysler, United States.
So we, sir, are at the end of the line in terms of automobile production in Europe when we should be at the front, at the head of the line.
Senator GORE. Well, if we continue the policies which you are advocating we are going to be at the end of the line in a very difficult way, in a number of instances.
What you have said is that a lower tax rate or deferral of tax liability results in a faster rate of growth.
Mr. SLOWINSKI. It results in paying off the debt for the building of the plants, money which we have borrowed on the foreign market in many cases.
Senator GORE. Well, doesn't that mean the same thing, faster rate of economic growth?
Mr. SLOWINSKI. And U.S. private investment owned abroad. U.S. companies own that investment, Senator.
Senator GORE. Would you accommodate me with an affirmative or a negative reply, if you can do so?
Mr. SLOWINSKI. Faster growth?
Senator GORE. Yes.
Mr. SLOWINSKI. Yes, sir.
Senator GORE. All right.
Therefore, that is the reason, you say, that they cannot compete successfully.
Mr. SLOWINSKI. If our competitors are growing quickly we must grow at least as quickly; this was the tenor of yesterday's discussion.
Senator GORE. You make yourself perfectly plain and clear.
Of course, there is one other way of providing the capital for plant expansion.
One is equity investment. I see no justification for giving tax deferral purely on the grounds that such tax deferral would provide for more rapid economic growth of U.S. corporate interests abroad——
Mr. SLOWINSKI. Senator, any——

Senator GORE. Excuse me just a moment—when we apply a tax annually to U.S. corporate interests in the United States. This comes to a point made by the Secretary of the Treasury yesterday, that present preferential tax treatment of income earned abroad provides an incentive for and a subsidy for more rapid growth of U.S. corporate interests abroad than for investments in the United States.

Just why we should subsidize and encourage development abroad, why we should penalize development in the United States, I do not quite understand.

Mr. SLOWINSKI. Senator, any private investment abroad by U.S. corporations has been made with after-tax dollars. If $100 is earned by a U.S. corporation, $52 is paid to the U.S. Government and only the remaining $48 is available for investment.

The technique of many U.S. companies in order to give private U.S. investment abroad a chance to compete has been to borrow foreign funds on foreign markets and the U.S. corporation then owns the equity in these investments which accounts for $2.65 billion being paid back in dividends and profits to the U.S. shareholders in 1961.

Our balance of payments, our flow of gold has been in favor of U.S. corporations doing this job. No one during the colloquy yesterday mentioned that the balance of payments may be unfavorable because of our large foreign aid program. No one mentioned this. But perhaps this is true.

Senator GORE. Of course, it is true.

Mr. SLOWINSKI. U.S. corporations and their subsidiaries have been earning money abroad and have been sending it home as dividends.

Senator GORE. We will come to that a little bit later if we may.

You have shifted gears into a different point.

You said that we were coming out at the little end of the line, or some such expression. Let me give you a few statistics to show how this is already happening.

I cite an article in the U.S. News & World Report of January 1, 1962, which reports on a study of 75 firms with substantial foreign sales.

In 1950, 36 percent of sales made abroad by these firms consisted of products produced in their foreign plants.

In 1955, this foreign produced component of their foreign sales was 56 percent. In 1960, 68 percent.

Now, in this connection I would like to ask you——

Senator KERR. Would the Senator make a premise there, I am very interested in his question.

Is the percentage of sales he refers to which were made in foreign areas or in the domestic market here?

Senator GORE. In foreign plants owned by these U.S. companies.

Senator KERR. I see.

Senator GORE. As a percentage of these companies' foreign sales.

You referred in your testimony earlier to a Brazilian subsidiary of a U.S. Corporation which purchased goods in Argentina.

Mr. SLOWINSKI. Yes, sir.

Senator GORE. And sold in Panama.

Mr. SLOWINSKI. Chile.

Senator GORE. Chile?

Mr. SLOWINSKI. Chile.

Senator GORE. You called that a U.S. business abroad.

Mr. SLOWINSKI. I call that Brazilian business abroad, Senator. But because a U.S. corporation owned more than 50 percent of the stock of that Brazilian company all of that income is foreign base company income taxable at 52 percent in the United States under section 13 of this bill.

Senator GORE. You don't think that should be taxable in the United States?

Mr. SLOWINSKI. I think it should be taxable at 52 percent in the United States when the Brazilian subsidiary declares a dividend up to its U.S. parent, less the credit for Brazilian taxes paid by that Brazilian company.

Senator GORE. I agree with you in one respect; a Western Hemisphere corporation has no particular merit.

Mr. SLOWINSKI. I didn't say that, Senator.

Senator GORE. This is——

Mr. SLOWINSKI. This is not a Western Hemisphere trade corporation, Senator, it is a Brazilian company.

Senator GORE. OK. We won't go into that.

My question is do you think the U.S. Government has a right, as you said the United States has a right, to look through the fictitious corporation in Lichtenstein?

Mr. SLOWINSKI. Yes, sir.

Senator GORE. To reach the interests of U.S. citizens and taxpayers?

Mr. SLOWINSKI. Yes, sir.

Senator GORE. In this corporation in Brazil?

Mr. SLOWINSKI. Sir?

Senator GORE. You said yes, twice.

Mr. SLOWINSKI. I said United States has a right to look into a fictitious corporation in Lichtenstein to reach the interests of U.S. citizens or corporations there.

Senator GORE. Yes.

Mr. SLOWINSKI. How we included Brazil escapes me, that is all.

Senator GORE. Well, do you think the United States has the same right to reach the interests of U.S. citizens with respect to the Brazilian subsidiary?

Mr. SLOWINSKI. Yes, sir.

Senator GORE. Then in the national interest it has a right to levy a tax either annually or as the profits are repatriated from this subsidiary?

Mr. SLOWINSKI. Senator, you and I agree but only if the profits are repatriated.

Senator GORE. It is not a question of right then, it is a question of policy.

Mr. SLOWINSKI. We are just talking about deferral in developed and less developed areas of the world and this is a good policy, we believe.

Senator GORE. Then, to repeat my question: You take the position that it is a question of policy, not a question of right?

Mr. SLOWINSKI. I am saying our law has been this way since 1918 and if the United States chooses to change section 11 of our law rather than put in new sections 951 through 958 in terms of foreign base company income, that this would be preferable.

Senator GORE. Well, we understand each other.

Earlier you made a point in an exchange with the Senator from Kentucky with respect to the outflow and the inflow of funds. I really don't wish to engage in colloquy on that because I thought the Secretary of the Treasury answered that very well yesterday in saying that the return from investment, cumulative investment, of many years is not to be equated with the capital outflow of 1 year.

Mr. SLOWINSKI. Senator, the figures I read this morning for 1960 or 1961 can stand on their own feet on a 1-year basis, and they are entirely favorable.

But we must realize——

Senator GORE. What I was suggesting to you was that the inflow which you cited in 1961 was an inflow from the cumulative investment throughout the history of the United States, and you compare that with the outflow of capital for investment of 1 year, but the Secretary of the Treasury made that point better than I can.

Mr. SLOWINSKI. The outflow, Senator, is also from foreign investments in the United States by foreign investors here since the history of the United States.

The outflow, for example, would include dividends paid by Underwood to Olivetti in Italy. You see the outflow also includes foreign investments in the United States.

Senator GORE. As I say, the Secretary of the Treasury covered that point yesterday and I will leave you and him to argue that point.

I did want to break down our statistics a bit differently, that is as between capital sent to Western Europe on the one hand, and capital sent to other parts of the world, on the other.

Likewise, the dividends remitted from Western Europe and from other areas.

Now, the figure for 1960 was that the capital sent from the United States to Europe was $607 million. Dividends remitted—these figures are for manufacturing subsidiaries——

Mr. SLOWINSKI. Yes.

Senator GORE. Dividends remitted $241 million.

Mr. SLOWINSKI. Senator, I just——

Senator GORE. And the Treasury recommendation, understand I am not in full agreement. I think we should require annual taxes on earnings in all countries, all foreign countries.

You understand the Treasury, and the Administration, recommends the repeal of the deferral privilege on earnings in developed countries.

Mr. SLOWINSKI. Yes, sir.

Senator GORE. I am speaking here now of the developed areas, I am speaking now of the effect of the recommendation of the Treasury Department with respect to Western Europe, manufacturing interests of U.S. corporations.

In 1960, $607 million went from here there; $241 million came from there here. But the figures you gave us were worldwide.

Mr. SLOWINSKI. Senator, I just returned from Western Europe last week.

Senator GORE. Were you acquainted with these figures?

Mr. SLOWINSKI. Yes, sir, the money invested in Western Europe in 1960 is in bricks and mortar just going into operation. You don't

return profits on bricks and mortar in a year. You may not do it in 3 years but I invite you through Belgium and the Netherlands where this money has been invested to see these plants not yet completed.

Senator GORE. I have been there, too, and if we continue to subsidize the movement of U.S. industry there, we are really going to be on the little end of the rope and that is what you advocate here.

Mr. SLOWINSKI. This is also advocated, Senator, in H.R. 9900, the trade bill, which says let's break the barrier so we can all do business as one group.

Senator GORE. Don't confuse that. This can't be equated with free trade or an interference with free trade.

This is a negative obstacle to free trade the same as the tariff is a positive obstacle to free trade. If you are to have an even flow of commerce you must remove the subsidy as well as the obstacle.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gore, are you through?

Senator GORE. Yes, sir.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. Let me ask one question.

As I understand basically what you are saying about investments overseas, the problem of investments must be made into an area where there is at least a potential market, isn't that true?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. In other words, no company, either American company or a foreign company, is going to make an investment unless they ultimately feel there is some way to return a profit.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And as you remarked concerning the automobile industry in Western Europe and since we are going to have the Common Market arrangement there is going to be a different type of competition between, let's say the various manufacturers like the French or the Germans or the Italians, whatever they be, for a Fiat or whatever automobile it is.

Mr. SLOWINSKI. Senator, for accuracy's sake, may I insert into the record, Mr. Chairman, the actual article which appeared in the last night's Star?

The CHAIRMAN. Without objection.

(The clipping referred to follows:)

Italy's Fiat is girding for a fight with Volkswagen.

Word comes that Fiat, ambitious to be the strongest of all Europe's auto makers when the Common Market tariffs disappear, is negotiating for 56 percent of the French Citroen stock.

This could mean a merger made further attractive by the fact that Citroen has control of Simca, which, in turn, is 25 percent Chrysler-owned.

Senator HARTKE. Ultimately so far as the people in the Common Market area are concerned just take as an example a rather modern community of purchasing ability, unless they have the purchasing ability it doesn't make much difference how much we can produce or how much they can produce, isn't that true?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. In this area if these people are successful, either by the tariff or by any other means in preventing any outside invest-

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ment of capital, then ultimately they may be able to provide the capital themselves for the investment so that they can produce the item which can be purchased in a country, and, therefore, they will obtain whatever profit there is to be made, which in turn will provide the nest egg. As an example, if you want to call it, the nest egg, for future investment into other items.

Mr. SLOWINSKI. That is correct, sir.

Senator HARTKE. Let me ask you this: As I understand the approach made by the Senator from Tennessee, his statement was that, and his thesis is that, he wants to provide the method of retaining the capital investment in the United States rather than to ship it overseas or have it taxed to such an extent as to create an equality of manufacturing in the United States as would occur overseas.

Senator GORE. Would the Senator let me state it in my words?

I seek to place U.S. tax policy in a position of neutrality. I do not wish to penalize foreign investment. I wish to remove the tax incentive for foreign investment. I do not wish to penalize investment in the United States by continuing the subsidy for foreign investment now in present law.

Therefore, to restate, I wish to place U.S. tax law in a position of neutrality with respect to international investment and commerce.

Senator HARTKE. I am willing to adopt the doctrine of neutrality for the moment.

Assuming, therefore, though that this occurred, the implication at the end of the line statement, the implication as I understood it was that the United States would ultimately end up in position where all of our people were going to be investing overseas under the so-called preferential treatment they are receiving today and would not invest in the United States.

Isn't this the potential implication of this type of reasoning?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And the net result means then that what we are saying in effect is that we are not capable of producing the type of investment incentive inside the United States in order to hold our own business at the present level.

Isn't that true?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And yet we know as a practical matter——

Senator GORE. Will the Senator yield?

Senator HARTKE. Yes, sir.

Senator GORE. It is not a question of incapacity to do it.

Senator HARTKE. I grant you this. This assumption makes that final deduction.

Senator GORE. No, I don't assume any incapacity. We can repeal the income tax in the United States. We can cut it. Many people advocate that.

In fact, we could give deferral of domestic tax liability. That is constitutional. This is what is done for foreign investment. So, I respectfully suggest, I assume no incapacity of the U.S. Congress to do it. I don't think that our fiscal position will permit us to do it.

Senator HARTKE. I am talking about the assumption——

Senator GORE. So was I.

Senator HARTKE. But the assumption leads to this discussion, and ultimately if this assumption is pursued to its ultimate end, which I hope no one would do, what we in effect would be doing would be to retrench all American capital to make all investment inside the United States and never go beyond the legal border of our country, isn't that the effect of it if carried to the ultimate?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And, therefore, we would leave to those countries——

Senator GORE. Which assumption are you talking about? I didn't indulge in an assumption.

Senator HARTKE. I did.

Senator GORE. Good. That is yours, not mine.

Senator HARTKE. For the sake of the record and my dear friend from Tennessee, let me adopt all assumptions as my own.

Senator GORE. Good.

Senator HARTKE. Because basically, does it make any difference what we try to do, there is no use trying to sell automobiles to camel riders.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And so there is an item which basically comes back to the fact that investments of funds will go to an area where a market potentially exists. If we are going to buy restrictive tax measures inside the United States, create an atmosphere which is going to be more restrictive of our own capital than it is of foreign capital, the foreign capital will find its way in and it will acquire these markets, and we will ultimately be left in the position of depending solely upon our economic progress and our future and our entire economic growth upon the ability to create the purchasing power solely within the United States of America.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. So this doesn't come back to a matter of just alone of trying to create a doctrine of equality. But this comes back to a question of whether or not in the field of investment as to whether or not the United States is willing to provide some type of incentive or whaever term you want to use, to encourage not alone the full potential investment of American capital into American business, but also to acquire our way of life, and our investment and our dollars to go into these foreign markets.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. Because if we don't fill that void, the way of economic development indicates that other countries will.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. I didn't know I was going to get such a cooperative witness.

Let me come back to another question, that is all I have on that matter, and I want no assumption for the Senator from Tennessee.

In regard to the matter of the question of deduction for attempts to influence legislation, the so-called lobbying aspects, I want to thank my distinguished witness for referring to my bill.

Let me ask you as a matter of practical application, isn't there a very difficult interpretative question involved so far as the law written in the House is concerned?

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Mr. SLOWINSKI. Yes, Senator, there is.

Senator HARTKE. Explain that for me.

Mr. SLOWINSKI. If, for example, a group such as the Chamber of Commerce of the United States were to be restricted to discuss with its members only matters in which it, as a trade association had a direct interest it would not, for example, discuss with its members this tax bill, this overall tax bill except insofar as section 4 is concerned.

We do not think that the associations which follow us as witnesses over the next 5 weeks should be restricted in their activities because our entire objection is to bring to you a full and fair consideration of your tax legislation in areas in which we may not have a direct interest.

Senator HARTKE. Because ultimately not alone is the effect going to be indirectly upon you in relation to the overall tax policy, but ultimately assuming that you people are interested in the future of our country, the future of the country is involved.

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. And I don't want to ascribe to any particular group or trade association, or lobbying group, that they are going to destroy its economic growth by their activity.

On the other hand, we all recognize being in legislative groups, that they do present their favorable side of the story; and we take it all sometimes with a grain of salt, is that right?

Mr. SLOWINSKI. And as frequently his side when we find two opposing groups we both object to the type of legislation which is being proposed and are submitting their views, that sometimes we find out we didn't satisfy either, we figure we have done a pretty good job in this regard.

Senator HARTKE. Let me ask you in regard to the public itself, according to the House bill, is it your understanding that there would be no permission for deduction for the so-called expression through any means of advertisements such as newspapers, radio, television, or even direct mail to inform the public on the matters of a legislative nature?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. Even though they might be only indirectly affecting the business concerned?

Mr. SLOWINSKI. That is correct, Senator.

Senator HARTKE. Doesn't this assume that the information—let me correct that before I get into another assumption which might be wrong.

Even though the nature of the information which might be submitted to the people, or the public at large, might be bypassed in favor of the organization which is submitting it, as long as it is properly identified, couldn't we assume the American people have the intelligence to make the distinction between recognizing the facts which they present and bringing those separate from the opinions which they present?

Mr. SLOWINSKI. They have in the past, Senator.

Senator HARTKE. And this thing, frankly, as far as the chamber of commerce is concerned and many of your activities could permit advertisements which might give information to the public which ultimately would formulate public opinion, which is to be reflected in the Congress or in any legislative body, as a net result of which it might

have a detrimental effect upon you as well as a positive effect upon the chamber?

Mr. SLOWINSKI. We think groups such as this should have the right to inform the public on legislation or on referendums.

Senator HARTKE. Under the present bill this is not possible, isn't that true?

Mr. SLOWINSKI. Yes, sir.

Senator HARTKE. Let's take in the case of bond issues in local communities.

What would be the effect of this type of legislation in regard to a bond issue for public improvement?

Mr. SLOWINSKI. If one were not a corporation, which was about to pay a portion of the expense of the bond issue, or one were not an individual who was about to pay a portion of the expenses of the bond issue, one probably couldn't participate under the provisions of the House bill because he didn't have a direct interest.

Senator HARTKE. And the net result would be that these advertising campaigns which frequently are required in order to stir up public opinion to take positive action to do things which frequently the bond issue seeks to do, would probably fail.

Mr. SLOWINSKI. Or that the wealthier groups which were not worried about tax deductibility would have the privilege of participating while the other groups would not.

Senator HARTKE. That is all I have, sir.

The CHAIRMAN. Thank you very much, Mr. Slowinski.

All the committee may not agree with what you have said but I want to say this, you have shown to my mind, a very remarkable knowledge of the tax laws. I note with some interest that you are a lecturer at the University of Virginia Law School.

Mr. SLOWINSKI. Yes, Mr. Chairman.

The CHAIRMAN. So the committee will now recess until 2:30 p.m.

Whereupon, at 12:20 p.m., the committee was recessed to reconvene at 2:30 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

We have sent for some of the other Senators, and I hope they will respond.

The first witness is Mr. Harold H. Scaff, National Association of Manufacturers. Take a seat, sir. I am sorry we have not got more Senators here, but I think they will come in very shortly.

STATEMENT OF HAROLD H. SCAFF, CHAIRMAN, TAX COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS; ACCOMPANIED BY JOHN C. DAVIDSON, VICE PRESIDENT IN CHARGE OF GOVERNMENT FINANCE DIVISION, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. SCAFF. My name is Harold H. Scaff. I am vice president of Ebasco Services, Inc., New York, N.Y. My presentation is in behalf of the National Association of Manufacturers as chairman of its taxation committee.

I have with me Mr. John C. Davidson who is a vice president in charge of the government finance division of the association.

The National Association of Manufacturers is a voluntary organization with approximately 17,000 members. Four out of five of our members are small business concerns. In fact, about 28 percent of NAM members have 50 or less employees, about 46 percent employ 100 or less and about 83 percent have 500 or fewer employees.

We appreciate the opportunity to appear in these hearings. Not only the National Association of Manufacturers but also many other groups and individuals are convinced of the necessity in the national interest for easing the impact of the tax structure on capital formation and economic growth. We, of the NAM, do not believe that H.R. 10650 would be a constructive move in this direction. Thus, we are opposed to its enactment.

GENERAL OBSERVATIONS

This bill, H.R. 10650, brings to a head the two great domestic problems of our times. One is the combination of Federal spending and taxing policies. The other is inadequate growth in our private economy. The former is the primary cause of the latter. If H.R. 10650 is enacted, it will compound these problems, making their solution more difficult hereafter. It is important, therefore, that this pending legislation be considered in the light of alternative fiscal and tax policies.

More specifically, H.R. 10650 should not be enacted because it would provide a green light for continued upsweep in Federal spending, and a red light against greater and more sustained growth in the private economy. In order to make these points clear, it is necessary to review the course of thinking on fiscal policy over recent years.

STOCKTAKING ON TAX POLICY

In the mid-1950's, some serious stocktaking began on the relation of tax policy to economic growth. Until that time, various factors had combined to provide a fairly satisfactory growth record in the postwar years. Signs were developing, however, that a slowdown was inevitable in the absence of much more growth capital than could be accumulated under the existing tax philosophy and structure. The inadequate record of growth in succeeding years has validated this early thinking. As a result, there is now broad recognition that the most serious block to long-range, high-level economic growth is a tax structure which is anticapital formation in basic design.

In the intervening years, a competing force has gotten much of the spotlight which should have been centered on the need for enactment of a program which would have released the tax brakes on capital formation and economic growth.

SO-CALLED LOOPHOLE CLOSING AND BASE BROADENING

The competing force is the so-called loophole-calling movement. This movement, in basic design, was and continues to be aimed at creating the false impression that upper income taxpayers, and business, escape their fair share of the tax burden, thus placing an unfair share on avearge and lower income taxpayers. This impression does

not accord with the facts as related to the total of exemptions, deductions, credits and exclusions in the tax law, which provides greater protection from payment of tax in the lower than in the higher income levels.

The loophole-calling movement received a nonideological covering by its identification with the theoretic concept of base broadening as the means of achieving lower tax rates. This concept does not contemplate any significant reduction in actual tax burdens. Hence, base broadening would have the result of releasing the tax brakes on economic progress only as the reshuffling of tax liabilities released capital from taxation. To do this, it would be necessary to shift actual tax burdens, measured by effective tax rates, from higher income groups and business, to lower income groups. If the opposite result were achieved; that is, an increase of effective tax rates on higher income groups and business, there would be reduction in the rate of capital formation, and hence even a lower rate of economic growth with more unemployment and lower Government revenues.

If the proponents of so-called loophole closing, or base broadening, do intend by this approach to effect a significant shifting of actual tax burdens down the income line, then they should say so. This would provide taxpayers generally with a new reason for taking a fresh look at fiscal policy.

However, if these proponents should not contemplate a significant shift of actual tax burdens down the income line, then they should forthrightly state that reshuffling of tax liabilities will not make material contributions to economic growth, instead of claiming the contrary. Such forthrightness also would provide the base for a fresh look at the need for spending reduction and control to permit release of tax blocks to economic progress.

A rationalization for so-called loophole closing, or base broadening, has been that Federal spending cannot be controlled; hence there is no possibility for substantial net tax reduction. This, in turn, gives greater plausibility to the base-broadening movement. One idea feeds the other, and both combine to defeat the public interest.

Starting with the coincidence of sputniks and a new recession, in the fall of 1957, the soft attitude in regard to public spending was made to appear more realistic by a new academic and political thrust re the asserted benefits to be derived from blowing up the so-called public sector of the economy. This approach has been carried so far as to assert that greater growth in the total economy is primarily dependent upon greater spending in the public sector.

To the present, efforts have been in vain to achieve Government policy recognition of the fact that the public sector is dependent on the private sector of the economy—that, while capital-destroying tax rates are in effect, greater growth in the public sector is at the expense of growth in the private sector. In helping to prevent such policy recognition, the so-called loophole-closing or base-broadening movement has been a disservice to the public welfare, including our national position of strength and prestige in the world. It has been particularly harmful to the segments of the American public dependent for good employment opportunities on greater capital formation and more rapid economic growth. These segments include the unemployed, the underemployed, and the new high school and college graduates.

GOVERNMENT FISCAL POLICY CAUSES LAG IN ECONOMIC GROWTH

Recently a new study has become available which provides quantitative documentation for the fact that Government fiscal policies are the essential cause of our poor growth performance. This is a study by Dr. Simon Kuznets of the National Bureau of Economic Research.[1]

Dr. Kuznets points out, as have many others, that the growth of scientific knowledge and technological skill is, of course, important to improvement of our economic productivity.

However, he goes on to say:

> One persistent bottleneck in the use of knowledge in economic production has been the scarcity of the resources for the production of capital goods needed for the application of new knowledge.

Dr. Kuznets demonstrates that over the past century gross capital formation—the part of current production diverted for use in producing future goods or income—has been a constant or slightly declining percentage of gross national product. However, the replacement requirement has been rising so steeply that net capital formation has been a drastically decining fraction of net national product. The drop (in contract prices) was from 14.6 percent in 1869–88 to 7 percent in 1946–55.

In seeking an explanation for this drop, Dr. Kuznets dismisses the theory that it is due to a decline in investment opportunities. After a long analysis of this claim he concludes:

> The alternative approach, which emphasizes the supply of savings, seems more plausible and more fruitful as an analytical lead.

Dr. Kuznets makes clear that Federal spending and tax policies, by draining away funds which otherwise could be saved for use in the private economy, were the principal cause of inadequate capital formation. He notes that the problem may not be so much the quantitative weight of the Government sector as it is the distribution of the tax burden in supporting the weight.

The spending and uneconomic taxing policies of the Federal Government not only are the cause of the inadequate rate of economic growth; they compound this cause whenever the Government inaugurates new spending programs essentially designed to cope with the problems created by the total of the earlier ones.

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Perhaps the best description of this bill is that it is a "many splintered thing." But, as everyone knows, the splintering is a purposeful means to readily identifiable objectives. The overall objective is to establish a precedent for tax manipulation and direction of our economic and social institutions. There is an implication here of tax solutions of nontax problems which is a contradiction of the nature of taxation. Taxes cause problems, but do not solve them. When we abandon the basic principle that the purpose of taxation is to raise revenue, we do not just enter into a sea which has not been heretofore

[1] "Capital in the American Economy," by Simon Kuznets and Elizabeth Jenks, Princeton Press, 1961.

charted. It is a sea which defies charting, heretofore or hereafter. I could think of no more treacherous waters than tax policy subject to change in purpose and direction by the whims and predilections of Government planners, from administration to administration.

In attempting to resolve nontax problems through tax manipulation, three areas of H.R. 10650 are particularly meaningful.

First, the proposed tax credit for investment is designed to introduce the subsidy principle into the tax law. It is well known that there is no instrument of government which has more insidious effect on the independence and freedom of action of affected parties than a subsidy. Those who are subsidized inevitably become more dependent on and subject to the control of government.

Second, the bill would withdraw the protection of business judgement afforded by the "ordinary and necessary" rule of expense deduction which has been embodied in the income tax law since its inception. It has been said that the application of this rule always has been a matter of "legislative grace," and that no protection for it is found in constitutional law. Nevertheless, it is the rule which says, in effect, that business shall pay income tax only on its net income or earnings. If the rule is abandoned in one area of business expense, the way obviously will be open for its abandonment in others.

Until the current attach on the "ordinary and necessary" rule, business had always taken comfort in the belief that the Congress in its wisdom tnd judgment would never intentionally legislate an abridgment of the rule in its application to otherwise lawful business expenditures. If the basis for this belief is destroyed, the result will be a new element of psychology in regard to business forward planning.

Third, in its application to unrepatriated income of foreign corporations, the bill would alter basic tax principles in regard to payment of tax only on realized income.

Such objectives raise broad philosophic questions which seemingly should not be resolved in tax legislation that, on net balance, has little to commend it on other grounds. If we are to change the basic nature of our American institutions, then we should debate and decide the issues on broad philosophic terms first, not move toward such objectives through the details of tax legislation promoted on other grounds.

I will now proceed to specific comments in regard to provisions of the legislation before you.

SECTION 2—CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

The proposed credit is a means for providing varying degrees of relief for some taxpayers but not for others. It is not in form or substance a part of, or in substitution for, or in addition to, or a companion of, depreciation reform. It would simply provide reduction in effective tax rates for taxpayers who use their income, or other funds, as the Government thinks is best for the economy at a particular time.

There has been a tendency to promote and discuss the investment tax credit apart from the price which it would exact in terms of other changes in the tax law. Even without the exaction of such a price, we would oppose the credit for the reasons set forth in the appendix attached hereto. Very simply, we believe that tax reduction should

be afforded by direct means. We would take this position even if, in our opinion, all of the other provisions of H.R. 10650 constituted sound tax policy.

Consistently, we would not favor legislation of the character of H.R. 10650, even if the tax reduction feature were of the kind to which we subscribe. Despite any seeming temporary advantage, we do not believe that the reshuffling approach offers significant promise for the reduction of the tax burden on capital accumulation and use. Instead, as I have indicated, we look upon it as providing a green light for more Federal spending, which would tend to perpetuate or even increase the restraint of taxation on capital formation and economic progress. This is why we say that H.R. 10650 would provide a red light against adequate growth in the private economy. We believe that the whole approach reflected in H.R. 10650 should be abandoned and that instead the Government should turn to an alternative program of releasing the tax blocks to economic growth, combined with reduction and control of the spending level.

SECTION 3—EXPENSES, ET CETERA, WITH RESPECT TO LEGISLATION

This section deals with the deduction of expenses in connection with the expression of business viewpoints on legislative matters, at all legislative levels. Such expressions are necessary to assure that laws do not impede or restrain the effective functioning of our private enterprise system. Consistently, expenses in connection with such expressions are "ordinary and necessary," and there is no statutory prohibition to the contrary. The present situation has been created by an interplay of administrative regulations, and court decisions, resulting from a failure of explicit statutory language on the subject.

The section as drafted, however, would draw a line through such expenses. It would permit generally the deduction of those which involve expressions directly communicated to legislative bodies, or members thereof. But it would deny deductions where expressions are designed to influence the general public, or segments thereof, in regard to legislative matters.

We appreciate the recognition which the Ways and Means Committee, on two occasions, and now the full House of Representatives, has given to this problem, but the provisions in H.R. 10650 do not come to grips with the full scope of the problem. To achieve an adequate resolution of the issue we urge consideration by this committee of the bill, S. 467, jointly sponsored by Senators Kerr and Hartke.

This bill would provide a comprehensive and equitable remedy by permitting the deductibility of legislative expenditures to the extent they would qualify as "ordinary and necessary" business expenses related to the business of the taxpayer and reasonable in amount. Clearly, the limitations indicated, as well as the discretionary authority left to the Internal Revenue Service, would provide adequate safeguards against possible abuse.

In light of the seriousness with which we view this problem, we propose to file a more extended statement of our views for inclusion in the record of these hearings.

SECTION 4—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ET CETERA, EXPENSES

As stated earlier, the effect of this section would be to withdraw the protection of business judgment afforded by the "ordinary and necessary" rule of expense deduction.

In some respects, the new rules would be completely arbitrary, substituting statutory for business judgment as to what is an "ordinary and necessary" business expense. In other respects, the new rules would delegate to the Revenue Service arbitrary power to substitute its judgment for business judgment as to what constitutes "ordinary and necessary" business expenses.

Section 4 provides that no deduction is to be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement or recreation, except to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. The Ways and Means Committee report states that objective standards will be applied, first as to what constitutes such an activity and, second, whether the purpose of expenditure is directly related to the active conduct of a trade or business.

These are fair-sounding words, but they run counter to experience. The Supreme Court and many lower courts have confirmed this experience in recognizing the impossibility of formulating specific and precise guidelines in this area without subordinating business judgment to Government fiat, as stated by Justice Cardozo in *Welch* v. *Helvering*:

> One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all of its fullness must supply the answer to the riddle. (290 U.S. 111 (1933).)

The fact that specific guidelines will inevitably produce an arbitrary result, denying to some taxpayers the deduction of expenses which reflect the best of business judgment, is underlined by the repetitive process of proposal, review, and rejection of various formulas in the course of the Ways and Means Committee's considerations of the administration's recommendations. It may be taken for granted that close study of the provisions of section 4 as now drafted will show that their application will inevitably produce arbitrary and capricious results.

Specifically, under the first test, any activity which is not directly related to the conduct of a particular business seems to fall in the entertainment-type area, which includes amusement and recreation. Under the second test, expenditures for such type activities will not be deductible if the value to the business is collateral rather than direct. On page A29 of the Ways and Means Committee report a particularly illuminating example of this type of situation is given, as follows:

> Another example of the role played by the taxpayer's business in determining the type of an activity would be in connection with a fashion show. If the taxpayer conducting the fashion show is the manufacturer of the dresses shown and the viewers are a group of store buyers, the show generally would not be considered to constitute entertainment, because the fashion show is, for a dress manufacturer, a method for introducing his product to the market. However,

If the taxpayer conducting the fashion show is an appliance distributor and th viewers are the retailers and their wives, the fashion show generally would b considered to constitute entertainment.

This illustration conjures the situation of a businessman consider ing two alternate promotion plans to increase his sales by a total of say, $1 million. One plan calls for an expenditure of, say, $50,000 fo local newspaper advertising. The other is an expenditure of $25,00 for putting on local entertainment-type promotions which his dealer argue might get equal or better results. The law would say that the latter is not a deductible expense.

The intention as indicated elsewhere in the committee's report, is to prohibit deduction where the value of an entertainment-type activity to the taxpayer is of an advertising or promotional nature. In effect the bill, as interpreted by the report and illustrated, says: It matters not the value to the taxpayer's trade or business of the activity—if there is any fun or pleasure in connection with it, it won't be deductible.

It would seem that any legislation in this area necessarily would go further than preventing abuses in regard to entertainment and other business expenses. It inevitably would restrict or disallow such expenses, in cases in which there could be no question as to the good-faith application of business judgment. In such cases, the taxpayer either would be inhibited from following his judgment or penalized to the extent of the applicable tax rate if he nevertheless incurred the affected expenditures.

The "ordinary and necessary" rule for determining deductibility of business expenses harmonizes tax law with business practices and accounting. It is an indispensable part of the computation of tax or net income. Restrictions of the rule, regardless of the formulas used, would require payment of tax on something in excess of true income. This would be economic confiscation, regardless of whether the courts would find it legal confiscation. In harassing, penalizing and confiscating income of the innocent, the proposals in this area make a sharp break from American traditions of fairness and justice.

Any legislation in this area will complicate rather than simplify the tax law, and compound rather than ease the problems of tax administration including audit.

To the extent that such legislative restrictions would prevent or inhibit business expenditures which otherwise would be made, there would be an adverse effect on total business activity and hence on Federal revenues.

To the extent that they deny deduction of actual business expense, they would have a comparable effect on business profits and capital supply. By and large, it may be assumed that the $125 million revenue effect estimated by the Treasury for these provisions would be reflected in comparable reduction in business net income.

We will file a more extended statement of our view on this subject in the record of these hearings.

SECTION 8—MUTUAL SAVINGS BANKS, ETC.—SECTION 17—TAX TREATMENT OF COOPERATIVES AND PATRONS

The NAM has long and strongly advocated equal taxation of competing enterprises, regardless of the form of doing business.

MUTUALS

The provisions of section 8 in regard to mutual savings banks and saving and loan associations fall short of full and equal taxation. The bill provides alternate methods for taxing these institutions, one of which would require payment of tax on only 55 percent of operating income, as compared with tax payment by commercial banks on about 80 percent of operating income.

COOPERATIVES

In terms of competitive economics, there is no reason why the tax burden on cooperative income should be less than that on regular corporations.

At a minimum the earnings of cooperatives should be taxed once either to the cooperative corporation if it retains the use and beneficial enjoyment of the income for growth or to the patron if the earnings are distributed in cash so that the patron may exercise full dominion and control thereover at the time received.

Section 19 imposes withholding on patronage dividends, and section 17 attempts to impose a single tax on co-op income by providing for a deduction on patronage dividends even if paid in so-called scrip, provided (1) the scrip can be converted into cash within 90 days at the option of the patron or (2) the patron has consented to include the amount of this scrip in his own income. This may be a written consent given directly by the patron and would remain in effect unless revoked.

Under a late revision of the bill by the Ways and Means Committee, cooperative member consent may also take the form of inclusion in the cooperative bylaws of a provision requiring patron members to pay tax on all such scrip. Under this arrangement, co-ops would retain earnings without taxation at the corporate rate since the patron would receive an allocated dividend subject to taxation at personal income tax rates, as if it had actually been distributed, while the funds—minus withholding—would remain with the co-op.

Industry had been hopeful that the provisions before the recent amendment would result in a substantial payout of cash by cooperatives to patron members or, as the alternative, that retained cash would be subject to full corporate tax rates. However, the provision for member consent through a provision in a cooperative's bylaws enhances the possibility that the bulk of cooperative earnings would be retained as cash for growth purposes. Such cash retentions would be subject in effect to a 20-percent tax (the amount of withholding) as compared with the top 52-percent rate paid by regular corporations. This would provide continued encouragement for the expansion of cooperatives, at the expense of their full taxpaying competitors, and consequent further loss of Federal revenues. It is an inadequate resolution of the problem.

SECTION 19—WITHHOLDING ON INCOME TAX AT SOURCE ON INTEREST AND DIVIDENDS

Withholding on salaries and wages is workable and generally equitable because of the allowance made for exemptions and deductions.

Using the same benchmarks, withholding as regards interest and dividends is not workable and would be generally inequitable. It would be a hit-or-miss proposition. Whenever the amount of tax liability happened to approximate the amount withheld, the result would be accidental. Withholding is not adaptable to this area, unless there is no intention that the amount of tax withheld should be expected to generally approximate the amount of tax due.

Withholding would be extremely inequitable as regards great numbers of taxpayers whose tax liability is substantially less than the amount which would be withheld. No system of quick refunds could change this fact. The provisions of the House bill permitting liberal use of exemptions where no tax liability is expected is adequate proof of this conclusion. There could be no material difference in the inequity of withholding at 20 percent in the case of a citizen who has no tax liability after exemptions and deductions, and in the case of one whose liability is only a small percent of the grant exemption certificates for all taxpayers who estimate that their tax liability is significantly below the amount which would otherwise be withheld.

Withholding on interest and dividends would add immense complexity and confusion to the administration of the tax laws. We could be sure that whatever the pattern of statutory provision and administrative regulation at the beginning, if withholding in this area should be instituted, there would be repetitive change and revision on a trial-and-error basis over the years.

In our opinion, and whatever the case for withholding on interest and dividends may have been heretofore, now is a most inopportune time to consider it.

Automatic data processing is scheduled for complete operation by 1966. The proposed withholding would first apply to the calendar year 1963. We cannot accept the statement that automatic data processing will prove efficient only in regard to unreported interest and dividend income of substantial amounts.

Regardless of whether it is profitable to follow up all tax returns in regard to which ADP revealed, or could reveal, unreported interest or dividend income, the fact that ADP would provide the Government with the necessary evidence as to evasion would be a powerful inducement to honest reporting. It is strange that the possibilities in this connection are not given full opportunity, instead of being discounted in advance.

Actually, institution of withholding might do more to interfere with faithful reporting and payment of tax on interest and dividends than to achieve this result. Last fall, Commissioner Caplin on one or more occasions publicly encouraged taxpayers who are delinquent in reporting and paying tax on interest and dividends to come clean. More recently, this kind of public encouragement seems to have been soft-pedaled in the interest of promoting the case for withholding. Certainly, the prospect of being caught by ADP, and the possibility that those who come clean before 1966 would be in better position than those who just get in under the deadline, should precipitate a maximum response to a continuing campaign of encouragement.

The anonymous character of withholding would enable any individual to escape detection by foregoing any claim to the 20 percent withheld from his interest or dividends. In other words, withholding is purely a revenue-collecting device, not only with no real regard to

tax liability, but also one which cannot be expected to make a net contribution toward uncovering evasion in this area, or toward compliance with the law in the future.

Withholding on interest and dividends would convert growth capital into Government spending through the speedup in time when taxes legally due are actually paid. Furthermore, it would defeat the objective of savers in placing funds at the maximum rate of compound interest.

REPEAL OF THE 4-PERCENT DIVIDEND CREDIT AND $50 DIVIDEND EXCLUSION

In his statement before this committee yesterday, Secretary of the Treasury Douglas Dillon again recommended repeal of the 4-percent dividend credit and $50 dividend exclusion. He estimates that the annual revenue gain from repeal would amount to $475 million.

Aside from the short-range expedient of gaining revenue, the Secretary repeats two points for repeal made last year before the Ways and Means Committee, namely—

(1) That the credit provides relatively greater tax relief to investors in high-income rather than in low-income brackets; and

(2) That the credit has been ineffective because "in the 8 years since (its adoption) the proportion of total corporate public long-term financing accounted for by stock issues has not been significantly higher than it was in the 8 years prior to 1955."

The first point is true only because of uneconomic tax rates. The argument could as well be made that all exemptions should be eliminated from the tax law because the dollar value of an exemption is greater in a high-income bracket than in a low-income bracket. It is past time to discontinue this kind of class-against-class tax talk, and give positive attention to the interest of citizens in the poorer income circumstances in greater capital formation and higher economic growth.

In regard to the second point, a table included in exhibit IV to the Secretary's statement shows an increase in average annual equity financing from $1.9 billion in the years 1946–53 to $3.3 billion in the years 1954–61. This is an average increase of $1.4 billion or 75 percent. This increase is approximately three times the estimated revenue effect of the credit and exclusion. Considering all factors, it would be reasonable to conclude that the amount invested in new corporate equities since 1954 would have been substantially less except for the credit and exclusion.

The factor which has been most discouraging in regard to equity financing has been a combined top corporate rate of 52 percent since 1954, as compared with a top rate of 38 percent between World War II and the Korean war. Stating this factor differently, if the corporate rate in recent years had been no higher than 38 percent it would be reasonable to believe that corporations would have been less inclined to take advantage of the deductibility of interest and more inclined to broaden the base of their equity ownership.

At the same time that the 52-percent corporate rate discouraged use of equity financing, it—combined with the wage-cost squeeze on profits—has forced corporations to seek greater external financing

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for expansion in plant and equipment. Under such pressures, it is somewhat surprising that they have not tended toward relatively greater recourse to debt financing.

Regardless of how much of the tax savings from the dividend credit and exclusion are directly invested in new corporate equities, the fact of stockownership is proof of the saving and investing habit. Thus it may be assumed that most of the tax savings from the credit and exclusion become new capital. Whether such capital is invested in equities, in corporate debt issues, or elsewhere, it becomes part of the total capital available for all uses in America. Repeal of the dividend credit and exclusion would eliminate this source of annual additions to total capital supply.

At a time when the national need for greater capital formation is so evident, and is in fact attested to by the administration's recognition of the connection between tax policy and economic growth, it is difficult to understand how there could be continued advocacy of the withdrawal or modification of tax provisions of particular importance to savers and investors or which otherwise contribute to the total volume of capital formation.

The way to begin reforming the tax structure to permit greater capital formation and economic growth certainly is not to take out of the structure provisions designed to serve that purpose.

Repeal of the dividend credit and exclusion would be a step backward in tax policy, reestablishing the full inequity of double taxation and reducing the annual increase in growth capital.

SECTIONS 5, 6, 7, 9, 13, 15, 16, 18, AND 21—TAXATION OF FOREIGN BUSINESS INCOME AND SO-CALLED TAX HAVEN OPERATIONS, ETC.

The proposal for altering time-honored rules for the taxation of business income earned abroad are said to be needed as a means for improving the present adverse balance of international payments. Such thinking is difficult to fathom. Apparently, it stems from a very short range view in regard to objectives to be achieved through changes in the tax structure; a view which is in sharp contrast with the long-range objectives of the administration's foreign trade program. Taking the two programs together, it seems that the administration is saying: "We want free trade, but slave capital." From an economic standpoint, freedom of capital could never fail to serve America's long-range economic interest.

There is no reason to believe that, on net balance, the provisions of H.R. 10650 requiring higher immediate taxation on foreign source income would have even a temporary, beneficial effect as regards the balance of international payments. It should be recognized that a typical American industrial corporation is neither just a domestic producer, nor just an exporter, nor just a foreign investor, but is a combination of all three. To assure the maximum American economic effort in all markets over the years ahead, and to build our economic strength and prestige in the world, short-range considerations should not be allowed to overrun long-range objectives.

BASIC CONSIDERATIONS

American business corporations invest abroad only because of the expectation of making profits for distribution to their shareholders at home. By and large, the profit expectation is not based on the original investment alone. Instead it is expected that the first profits abroad will be reinvested, and that this process will continue in part as regards subsequent profits. It is these reinvested profits which in large part account for the return flow of income to shareholders, and revenue to the U.S. Government. Any action which serves to diminish the reinvestment of profits either will result in a reduced return flow of income at a subsequent time, or be matched by a greater immediate outflow of capital. When the building of capital abroad through reinvestment takes place in countries where tax rates are lower than ours, the need for export of American capital is relatively the lowest in order to accomplish given objectives in regard to production and markets.

Thus, it is apparent, that domestic tax policy which is most favorable as regards foreign investment will precipitate the maximum long-range return flow of income with a minimum outflow of capital.

SHORT-RANGE EFFECTS

In 1961, income from direct foreign business investments totaled $2.4 billion, whereas direct new capital outflow amounted to only $1.6 billion. The indications are that these relationships are being approximately maintained in 1962.

In making the case for altering the historic tax rules for treatment of foreign business income, emphasis has been placed on the fact that the outward flow of capital to developed countries is greater than the return income flow, while the situation is reversed as regards the underdeveloped countries.

The assumptions that changes in the tax rules would, in the short range and in and of themselves, effect a significant change in this pattern, or increase the relation of return income flow to capital outflow, lack foundation.

First, in some situations, there undoubtedly would be some withdrawal of foreign earnings which otherwise would be used for reinvestment, in amount necessary to pay the additional taxes. To the extent which business judgment dictated, however, and funds are available, these withdrawals would soon be matched by comparable additions to outflow of capital. To the extent that this happened, there would be reduction in capital available for domestic investment, without change in the balance-of-payments situation.

Second, in many if not most situations, the disposition would be to pay the additional immediate tax liabilities out of domestic earnings of the parent corporation. In this event there also would be a reduction in capital supply for domestic use, without net affect on the balance-of-payments situation.

LONG-RANGE EFFECTS

To the extent that the short-range objectives for forcing a greater current return income flow, and a reduced capital outflow, are not frustrated by the factors recounted above, there would be adverse

effect on the long-range relation of capital outflow, and return flow of income. The latter would be less than otherwise would be expected, and the former might well be greater.

In the absence of adverse tax or other policies, it is to be expected that the spread between total outflow of capital and return flow of income will gradually increase over the years, and especially that the return flow from Western Europe will by the mid, to the late, 1960's overrun the capital outflow to that part of the world.

However, if the national policy of encouraging greater investment in the less developed countries should result in a greater flow of capital to those areas for manufacturing and distributive purposes, as contrasted to extraction of minerals there would be a period of digestion in which the return income flow would not move upward as fast as the capital outflow.

INVEST ECONOMICS AND THE EUROPEAN COMMON MARKET

The capital which goes to Europe, or elsewhere, is not in lieu of domestic investment for production of goods intended in whole or in part for export. The purpose of foreign investment is to preserve or expand the market for goods and services of American enterprises. Such investments are made when it is good business to do so. Instead of being at the expense of exports, investment abroad creates markets for U.S.-made goods in two ways:

First, it provides an immediate market for U.S.-made producers' equipment, and subsequent markets for U.S.-made prefabrications and components; and

Second, consistent with the fact that the best markets for American goods are in the more developed areas of the world, the greater economic activity generated by American investments abroad expands the markets in foreign countries for U.S.-made goods.

It should not be believed that discouragement of investment in Western Europe at this time would be compensated for by a subsequent reversal of policy in this respect. The breadth and depth of American enterprise is still greater than that of any other country, or combination of countries. If we do not invest abroad while this situation exists, we would be foregoing a major opportunity to improve the longrange income inflow from investments. Especially, it is of the utmost importance that American investment be made in Western Europe in the formative years of its Common Market, before European companies preempt the best opportunities. This will provide the greatest return flow of income. There can be no question, looking back from, say, 1970, that American investments in Europe and elsewhere will have proven to be an increasingly favorable factor as regard the balance of international payments, not to mention our total position of economic strength and prestige in the world and vis-a-vis the Communists.

GROSS-UP NOT BASED ON EQUITY

The points made above provide a solid case against the application of so-called "gross-up." However, arguments which require attention have been made as regards the equities in this area.

First, the argument has been made that "gross-up" is necessary in order to create equity between American corporations conducting their

foreign business operations through subsidiaries, on the one hand, and branches, on the other. Actually, many American corporations conduct some of their foreign operations through subsidiaries, and some through branches. However, the companies whose operations are wholly or mostly on a branch basis have not complained about the tax treatment of subsidiary operations. The fact, which has been often made but lost sight of, is that the nominal tax advantage of the subsidiary is often outweighed by other factors which benefit a branch operation, although such factors will vary from country to country. There are many factors other than taxes which influence a business decision to use a branch rather than a subsidiary operation, or vice versa.

Second, the argument is made that "gross-up" is necessary in order to create tax equity between American corporations engaged only in domestic operations, and those which also conduct foreign business operations.

There are several points to be made which make this thesis less tenable than would appear at first blush. The corporate income tax is only one of the taxes directly or indirectly borne out of business income, both at home and abroad. If all taxes were taken into account, in many cases instead of the apparent statistical equality when the foreign corporate rate is 52 percent, the total charge against the foreign income would be significantly greater than if the income had been derived within the United States.

Moreover, despite the uniform Federal top corporate tax rate, the total direct and indirect charges against income of American corporations will vary according to its exposure to State and local taxes as well as other Federal taxes.

In other words, there is no reason to believe that, if "gross-up" were enacted, there would be greater effective tax equality as between different corporations than there is at present. In fact, the overall tax discrimination now existing against foreign subsidiaries in many cases would be compounded. Certainly, the national interest in preserving the existing tax treatment of foreign business income is greater than any case which can be made for "gross-up" on the basis of statistical apparencies.

SO-CALLED TAX HAVEN MISUNDERSTOOD

The provisions designed to imposed immediate income tax on U.S. corporate shareholders of so-called tax haven companies, are contrary to the national interest. They do not reflect understanding of the national benefits which result from maximization of profits in such companies and the free use of those profits in further foreign investment.

As stated earlier, the efforts to impose tax on unrepatriated business income would establish a dangerous precedent for disregarding corporate entities in the imposition of tax. Apart from the implications of such a precedent, the provision in question should not be enacted, for the following reasons:

(*a*) The transaction of business abroad through foreign operating companies is essential in order to maintain the world competitive position of American-owned enterprises. The existing tax treatment of income from such companies has been an integral part of our tax

structure since the beginning of the income tax, and is in no sense a loophole.

(*b*) The location of such foreign operating companies in low-tax countries provides definite advantage as regards the balance-of-payments situation, because reinvested profits will be greater than in high-tax countries and the outward flow of new capital from America will thus be less. The purpose of locating in such countries is to minimize the burden of foreign tax, not of the U.S. tax. By minimizing foreign tax, and reinvesting profits, the greatest long-range flow of income to the United States will be produced. This, in turn, will maximize the U.S. tax revenue over the same years.

(*c*) The fact that serious constitutional questions are raised whether the U.S. income tax can reach undistributed operating income of foreign corporations is, in and of itself, a major reason for rejecting the provisions.

(*d*) These provisions are extremely complex and, if enacted, would impose formidable administrative burdens upon both the taxpayer and the Government. This complexity is inherent, and while some improvements might be made in the provisions, there are no improvements which would change their fundamental character.

(3) The U.S. Treasury Department already possesses powerful weapons to deal with such abuses of so-called tax haven companies as may be assumed to exist. These include the right to construe transactions according to their economic substance, rather than their legal form; and the right to allocate income and expense between entities on the basis of economic realities. We would caution however, against the exercise of this right where the result would be to increase current U.S. tax at the expense of maximization of reinvestment of profits abroad.

EFFECT OF H.R. 10650 ON CAPITAL SUPPLY AND USE

Under the provisions of H.R. 10650, American manufacturing companies as a whole would receive much more tax reductions through the investment tax credit than they would lose from the revenue-gaining provisions of the bill. Such a pragmatic benchmark of self-interest however is not appropriate to this kind of legislation for a number of reasons:

(1) The overall and subsidiary objectives of the legislation, as summarized on pages 5 and 6 of this statement, are inimical to sound tax policy and the most effective functioning of our free economy over the years.

(2) The welfare of a business corporation cannot be considered apart from the welfare of its owners, its creditors, its employees, and its customers.

(3) In looking ahead to tomorrow's markets and profits, manufacturers could hardly expect that they would gain from any continuing program of shifting of tax dollars from one pocket to another.

(4) In the total economic sense, the important thing to our Nation's economy, and hence to manufacturing companies, is the total volume of capital which is available to serve the purposes of progress. As much as we believe that the national interest would be served by diminishing the tax burden on corporate profits, we also know that this interest would be equally served by increasing the quantity of new,

mobile venture capital in the hands of individuals. Because of steeply progressive rates of tax on individual incomes, on estates and gifts, and of the taxation of gains on investment switches, the shortage of venture capital has been and continues to be one of the most critical factors in our economy since World War II. We would not want to compound this problem by a tax reshuffling process.

(5) In the ultimate economic sense, the value for economic progress of H.R. 10650 must be determined on the basis of its effect on total capital supply, regardless of whether particular provisions or objectives of the legislation are otherwise compatible with the public interest and equitable in nature. More specifically, additional taxation of mutual savings banks and insurance companies, and cooperatives, would have the immediate effect of diminishing capital available through these channels.

(6) Despite claims to the contrary, there is no reason to believe that the effect on capital formation of an investment tax credit would be any greater than would result from the release of a comparable number of tax dollars through tax rate reduction. A company would be just as free to remit to owners part of the tax savings from such a credit as it would be in regard to the tax savings from a rate reduction. It is much easier to bring the issues involved in H.R. 10650 into proper focus when this simple fact is recognized.

(7) Including the recommended repeal of the 4-percent dividend credit and $50 exclusion, a large part of the revenue gain from H.R. 10650 would amount to a subtraction from established capital in the hands of individuals. Corporate income taken by the revenue-gaining provisions of the bill would, except for the new taxation, be exposed to the same alternatives of reinvestment or remittal to owners as would apply to tax savings under an investment tax credit or tax rate reduction. When the effect on retained earnings of cooperatives and mutuals is added to this picture, it is clear that H.R. 10650 could not conceivably make an addition to net capital supply, but, more likely, would result in reduction thereof.

(8) Since greater economic growth, the provision of new and better jobs, greater advance in living standards, and greater national strength and security, are dependent upon the release of capital from taxation, it is improper to claim that H.R. 10650 would make any net contribution in this respect.

ALTERNATIVE TAX AND FISCAL POLICY

In its recognition of the connection between tax policy and capital formation, economic growth and job creation, the administration has set the stage for searching inquiry on a subject critical to the Nation's future. Unfortunately, H.R. 10650, or any other legislative application of the reshuffling theory embodied therein, would be ineffective in regard to growth and jobs. The problem remains, but it is clear that its resolution can be found only in some alternative approach to the tax and fiscal problems.

The alternate approach necessarily should be designed to provide a green light for greater growth in the private economy, and a red light against further uncontrolled Federal spending.

One of the misconceptions on the American scene is that we always have enough capital, perhaps too much at times. Nothing could be

further from the truth. There is no such thing as too much capital; there is no such thing as idle capital. When more capital is accumulated, it will be used.

Consistently, whatever restrains the accumulation of capital, whatever destroys capital once accumulated—limits economic growth. The more capital that is accumulated in any nation, the greater will be its progress.

As cited earlier in this statement, the new study by Dr. Kuznets buttons down the fact that Government spending and taxing policies are the root cause of inadequate capital formation and economic growth over recent years.

On the one hand, uneconomic tax rates and methods restrict capital accumulation and destroy capital once accumulated.

On the other, the Government continues to use for increased spending on new and old programs revenue which should be retained in the private economy through reform of tax rates and methods.

To serve the national interest, it would be necessary to reverse these policies. This would mean—

On the one hand, inauguration of an orderly plan for moderation of the tax rates and methods which restrict capital accumulation and destroy capital once accumulated, and

On the other, forbearance by the Government from spending on new and old programs the revenue which the reform of uneconomic tax rates and methods would leave in the private economy.

There are five major tax blocks to high-rate, long-range economic growth, namely:

Steeply graduated individual tax rates.

Excessive top rate of corporate tax.

Unrealistic length of lives and classification of depreciable property.

Taxing of gains on transfers from one investment to another.

Destructive rates of estate and gift taxes.

Reform of these rates and methods would open the way toward reinstating the American economy as the most dynamic in the world. Such reform would provide new opportunity to prove that capital in a free society is more productive of good for more people than under any other system.

Three years ago, two members of the House Ways and Means Committee, Representatives A. S. Herlong, Jr., of Florida, and Howard H. Baker of Tennessee, introduced legislation to accomplish such reform. This original bill has been introduced in the Senate (S. 2932) by Senator Tower of Texas. During its recent deliberations on the administration's tax program, as now embodied in H.R. 10650, the Ways and Means Committee tabled a motion to report out the Herlong-Baker legislation by a vote of 14 to 11. In making his motion, Representative Herlong advanced the effective dates of the legislation, and proposed a substitution for the provision in regard to depreciation reform. The manner in which this legislation would reform tax rates and methods which restrain economic progress may be briefly summarized:

PERSONAL INCOME TAX

THE PROBLEM

The ruthless graduation chokes off venture capital at its source, discourages risk taking, smothers incentives, curtails business starts and expansion, prevents job creation and is the major deterrent to adequate long-term economic growth.

It is the scourge of small business and of the man on the ladder.

By exacting stiff penalties on hard work and long hours, graduation is in direct conflict with the universally accepted principle of reward for extra effort and achievement.

Rates top out at 91 percent and hit 50 percent at $16,000 of taxable income from a start of 20 percent.

THE SOLUTION

Over a 5-year period the rates would be stringently compressed with the top rate reduced to 47 percent and the other graduated rates lowered in a consistent pattern.

Every personal taxpayer would get a minimum reduction of 25 percent with the first rate reduced to 15 percent.

On the principle that no unincorporated business, professional person, or other individual taxpayer, should pay a higher tax rate than a corporation, the new top of 47 percent would be the same as that on corporate income.

CORPORATE INCOME TAX AND DEPRECIATION

THE PROBLEM

The excessive top rate severely limits retained earnings, an important source of business expansion and job creation.

The tax takes 30 percent of profits up to $25,000 and 52 percent above that. More of current business income, incorporated and unincorporated, is subject to excessive tax rates because of continued requirement of depreciation allowances based on length of property lives which are unrealistically long in this period of rapid technological change.

THE SOLUTION

Five annual reductions of 1 percentage point each would be made, bringing the top corporate rate down to 47 percent and the first rate to 27 percent. For depreciation purposes the required time for writing off new property would be reduced by 25 percent on the average.

On top of the double declining balance and sum-of-the-years digits methods established by the 1954 code revisions this would mean a 33-percent increase in the rate of property writeoff.

The legislation would also substitute broad property groupings for present detailed classifications, providing greatest depreciation relief where taxpayers are most unfairly treated.

CAPITAL GAINS—ESTATE AND GIFT TAXES

THE PROBLEM

The tax on capital gains converts capital into current Government spending whenever an asset is sold at a gain.

Estate and gift taxes also result in conversion of accumulated capital to government use. Capital taxed away must be replaced by new savings out of current income before there is any net addition to capital supply.

In penalizing the movement of capital the capital gains tax also discriminates against new, risky, job-creating enterprises.

The maximum long-term capital gains rate is 25 percent; the rates on estates go from 3 to 77 percent; those on gifts from 2.25 to 57.75 percent.

THE SOLUTION

Following the rollover principle applied on the sale and repurchase of homes, the tax on long-term capital gains for individuals would be deferred until the taxpayer fails to reinvest the proceeds from the sale of affected property. To qualify for deferral, transfers between investments would have to take place within the same taxable year.

The top rate of the estate tax would be reduced to 47 percent; the top gift-tax rate to 35.25 percent, and all lower rates of both taxes would be reduced in proportion.

In a recent letter to organizations supporting the Herlong-Baker legislation, Representative Herlong provided some estimates in regard to the revenue cost of effectuation in fiscal year 1963, and also in regard to depreciation alone over a period of several years, as follows:

> On the assumption that enactment of H.R. 2030 as encompassed in my motion, would so influence the economy as to result in a gross national product of $570 billion in calendar year 1963, we estimated that total budget receipts would be $90.4 billion in fiscal year 1963. In the absence of enactment of H.R. 2030, we estimated that gross national product in calendar year 1963 would not exceed $560 billion and that revenue in fiscal year 1963 would total $92.3 billion. If, because of enactment of H.R. 2030, Federal expenditures in fiscal year 1963 were held $1.9 billion below those to be expected upon continuation of current trends, then it would be accurate to say that enactment of this legislation would have no adverse effects as regards the total budget picture for fiscal year 1963—while adding $10 billion to the total goods and services provided by our economy.
>
> Our estimates of the revenue effect of depreciation reform contemplated in the substitute for section 6 are: $400 million in fiscal year 1963; $1.1 billion in fiscal year 1964; and $1.6 billion in fiscal year 1965, with only moderate further step-ups in revenue effect in a few succeeding fiscal years.

By enacting this legislation, Congress would be setting the general public interest in greater economic growth above all other domestic considerations.

The public interest in control of competitive spending would be enforced by a provision requiring postponement of forward-scheduled rate reductions when budget unbalance is threatened. This provision would pose a clear choice for the executive branch, and the Congress, each year. If together these branches of Government did not apply a red light against increased spending, the private economy would suffer by postponement of the upcoming rate reductions.

In view of the failure to control the upsweep in Federal spending through other means, the Herlong-Baker legislation would be worth a try if fiscal integrity were its only goal.

As the economy responded in greater economic growth from more moderate tax rates, there would be consistent enlargement of the Federal tax base and soon a greater and steadier revenue flow than could be expected under present tax and fiscal policies.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Scaff.

Any questions?

Senator CURTIS. I have a question or two. This bill is rather long and covers many subjects; is that right?

Mr. SCAFF. Yes, sir.

Senator CURTIS. Would you mention the two or three or four, whatever it is, subjects in here to which you are the most opposed and cause you to suggest that the entire bill not be enacted? Just name them.

Mr. SCAFF. Well, we are opposed basically to the entire bill because we feel that it does not accomplish the objectives that are so desirable to our country at this time.

Senator CURTIS. I understand.

Mr. SCAFF. That is the development of a tax structure that will give us provisions for economic growth.

Senator CURTIS. I understand that.

Now, in addition to that, I take it that you are specifically opposed, and greatly opposed, to certain portions of the bill?

Mr. SCAFF. We voice opposition to the investment tax credit.

Senator CURTIS. What else?

Mr. SCAFF. We voice opposition to the expense account, the disallowance of entertainment expenses, certain entertainment expenses; we voice opposition to withholding.

Senator CURTIS. Do you favor the sections relating to the taxation of foreign income?

Mr. SCAFF. No, sir; we do not.

Senator CURTIS. Now, are there any portions of the bill to which you have no strong objections, which are not in conflict with your basic theory and belief in regard to taxation, spending, and fiscal policy generally?

Mr. SCAFF. We think the two sections in the bill that do not go far enough are the sections relating to cooperatives and the savings and loans.

Senator CURTIS. But you are not opposed to what is in there?

Mr. SCAFF. We feel that they do not go far enough.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. Mr. Scaff, I take it, after listening to your statement and following through as rapidly as I could, that your organization favors a tax structure and a tax program that would create an accumulation of capital that would, as a private enterprise program, give additional employment in this country; is that correct?

Mr. SCAFF. That is right, sir.

Senator CARLSON. Can you tell us how many dollars would be invested or are invested or are required to put one individual to work in our private enterprise system? Do you have those figures?

Mr. SCAFF. I think the figure has been said all the way from $15,000 to $18,000 currently.

Senator CARLSON. Well, as I understand it, then, if we really wanted to get this economy moving, a tax reduction program would probably be the most effective and most rapid way to do it.

Mr. SCAFF. We believe so; yes, sir.

Senator CARLSON. I have appreciated very much your statement. I share your views in regard to this.

I think we are really on the wrong track when we try to get the Government to lose the kind of money that they are going to lose as a result of this. As I view this unemployment problem over the past years, I do not believe we are going to get our economy moving or increase the gross national product until we get a tax structure that is appropriate for that purpose, and I hope this committee will take plenty of time to review this matter before us.

I appreciate your statement very much. That is all, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Scaff. It is a very able statement, and we appreciate your coming.

(Mr. Scaff's prepared statement follows:)

STATEMENT OF HAROLD H. SCAFF ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

My name is Harold H. Scaff. I am vice president of Ebasco Services, Inc., New York, N.Y. My presentation is in behalf of the National Association of Manufacturers, as chairman of its taxation committee.

The National Association of Manufacturers is a voluntary organization with approximately 17,000 members. Four out of five of our members are small business concerns. In fact, about 28 percent of NAM members have 50 or less employees, about 46 percent employ 100 or less and about 83 percent have 500 or fewer employees.

We appreciate the opportunity to appear in these hearings. Not only the National Association of Manufacturers but also many other groups and individuals are convinced of the necessity in the national interest for easing the impact of the tax structure on capital formation and economic growth. We, of the NAM, do not believe that H.R. 10650 would be a constructive move in this direction. Thus, we are opposed to its enactment.

GENERAL OBSERVATIONS

This bill, H.R. 10650, brings to a head the two great domestic problems of our times. One is the combination of Federal spending and taxing policies. The other is inadequate growth in our private economy. The former is the primary cause of the latter. If H.R. 10650 is enacted, it will compound these problems, making their solution more difficult hereafter. It is important therefore that this pending legislation be considered in the light of alternative fiscal and tax policies.

More specifically, H.R. 10650 should not be enacted because it would provide a green light for continued upsweep in Federal spending, and a red light against greater and more sustained growth in the private economy. In order to make these points clear, it is necessary to review the course of thinking on fiscal policy over recent years.

Stocktaking on tax policy

In the mid-1950's, some serious stocktaking began on the relation of tax policy to economic growth. Until that time, various factors had combined to provide a fairly satisfactory growth record in the postwar years. Signs were developing, however, that a slowdown was inevitable in the absence of much more growth capital than could be accumulated under the existing tax philosophy and structure. The inadequate record of growth in succeeding years has validated this early thinking. As a result, there is now broad recognition that the

most serious block to long-range, high-level economic growth is a tax structure which is anticapital formation in basic design.

In the intervening years, a competing force has gotten much of the spotlight which should have been centered on the need for enactment of a program which would have released the tax brakes on capital formation and economic growth.

So-called loophole closing and base broadening

The competing force is the so-called loophole-closing movement. This movement, in basic design, was and continues to be aimed at creating the false impression that upper income taxpayers, and business, escape their fair share of the tax burden, thus placing an unfair share on average and lower income taxpayers. This impression does not accord with the facts as related to the total of exemptions, deductions, credits, and exclusions in the tax law, which provides greater protection from payment of tax in the lower than in the higher income levels.

The loophole-closing movement received a nonideological covering by its identification with the theoretic concept of base broadening as the means of achieving lower tax rates. This concept does not contemplate any significant reduction in actual tax burdens. Hence, base broadening would have the result of releasing the tax brakes on economic progress only as the reshuffling of tax liabilities released capital from taxation. To do this, it would be necessary to shift actual tax burdens, measured by effective tax rates, from higher income groups and business, to lower income groups. If the opposite result were achieved, that is, an increase of effective tax rates on higher income groups and business, there would be reduction in the rate of capital formation, and hence even a lower rate of economic growth with more unemployment and lower Government revenues. If the proponents of so-called loophole closing, or base broadening, do intend by this approach to effect a significant shifting of actual tax burdens down the income line, then they should say so. This would provide taxpayers generally with a new reason for taking a fresh look at fiscal policy.

However, if these proponents should not contemplate a significant shift of actual tax burdens down the income line, then they should forthrightly state that reshuffling of tax liabilities will not make material contributions to economic growth, instead of claiming the contrary. Such forthrightness also would provide the base for a fresh look at the need for spending reduction and control to permit release of tax blocks to economic progress.

A rationalization for so-called loophole closing, or base broadening, has been that Federal spending cannot be controlled; hence there is no possibility for substantial net tax reduction. This in turn gives greater plausibility to the base-broadening movement. One idea feeds the other, and both combine to defeat the public interest.

Starting with the coincidence of sputniks and a new recession, in the fall of 1957, the soft attitude in regard to public spending was made to appear more realistic by a new academic and political thrust re the asserted benefits to be derived from blowing up the so-called public sector of the economy. This approach has been carried so far as to assert that greater growth in the total economy in primarily dependent upon greater spending in the public sector.

To the present, efforts have been in vain to achieve Government policy recognition of the fact that the public sector is dependent on the private sector of the economy—that, while capital-destroying tax rates are in effect, greater growth in the public sector is at the expense of growth in the private sector. In helping to prevent such policy recognition, the so-called loophole-closing, or base-broadening movement has been a disservice to the public welfare, including our national position of strength and prestige in the world. It has been particularly harmful to the segments of the American public dependent for good employment opportunities on greater capital formation and more rapid economic growth. These segments include the unemployed, the underemployed, and the new high school and college graduates.

Government fiscal policy causes lag in economic growth

Recently a new study has become available which provides quantitative documentation for the fact that Government fiscal policies are the essential cause of our poor growth performance. This is a study by Dr. Simon Kuznets of the National Bureau of Economic Research.[1]

[1] "Capital in the American Economy," by Simon Kuznets and Elizabeth Jenks, Princeton Press, 1961.

Dr. Kuznets points out, as have many others, that the growth of scientific knowledge and technological skill is of course important to improvement of our economic productivity. However, he goes on to say: "One persistent bottleneck in the use of knowledge in economic production has been the scarcity of the resources for the production of capital goods needed for the application of new knowledge."

Dr. Kuznets demonstrates that over the past century gross capital formation—the part of current production diverted for use in producing future goods or income—has been a constant or slightly declining percentage of gross national product. However, the replacement requirement has been rising so steeply that net capital formation has been a drastically declining fraction of net national product. The drop (in constant prices) was from 14.6 percent in 1869–88 to 7.0 percent in 1946–55.

In seeking an explanation for this drop, Dr. Kuznets dismisses the theory that it is due to a decline in investment opportunities. After a long analysis of this claim he concludes: "The alternative approach, which emphasizes the supply of savings, seems more plausible and more fruitful as an analytical lead."

Dr. Kuznets makes clear that Federal spending and tax policies, by draining away funds which otherwise could be saved for use in the private economy, were the principal cause of inadequate capital formation. He notes that the problem may not be so much the quantitative weight of the Government sector as it is the distribution of the tax burden in supporting that weight.

The spending and uneconomic taxing policies of the Federal Government not only are the cause of the inadequate rate of economic growth; they compound this cause whenever the Government inaugurates new spending programs essentially designed to cope with the problems created by the total of the earlier ones.

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Perhaps the best description of this bill is that it is a "many splintered thing." But, as everyone knows, the splintering is a purposeful means to readily identifiable objectives. The overall objective is to establish a precedent for tax manipulation and direction of our economic and social institutions. There is an implication here of tax solutions of nontax problems which is a contradiction of the nature of taxation. Taxes cause problems, but do not solve them. When we abandon the basic principle that the purpose of taxation is to raise revenue, we do not just enter into a sea which has not been heretofore charted. It is a sea which defies charting, heretofore or hereafter. I could think of no more treacherous waters than tax policy subject to change in purpose and direction by the whims and predilections of Government planners, from administration to administration.

In attempting to resolve nontax problems through tax manipulation, three areas of H.R. 10650 are particularly meaningful.

First, the proposed tax credit for investment is designed to introduce the subsidy principle into the tax law. It is well known that there is no instrument of government which has more insidious effect on the independence and freedom of action of affected parties than a subsidy. Those who are subsidized inevitably become more dependent on and subject to the control of government.

Second, the bill would withdraw the protection of business judgment afforded by the "ordinary and necessary" rule of expense deduction which has been embodied in the income tax law since its inception. It has been said that the application of this rule always has been a matter of "legislative grace," and that no protection for it is found in constitutional law. Nevertheless, it is the rule which says, in effect, that business shall pay income tax only on its net income or earnings. If the rule is abandoned in one area of business expense, the way obviously will be open for its abandonment in others.

Until the current attack on the "ordinary and necessary" rule, business had always taken comfort in the belief that the Congress in its wisdom and judgment would never intentionally legislate an abridgement of the rule in its application to other wise lawful business expenditures. If the basis for this belief is destroyed, the result will be a new element of adverse psychology in regard to business forward planning.

Third, in its application to unrepatriated income of foreign corporations, the bill would alter basic tax principles in regard to payment of tax only on realized income.

Such objectives raise broad philosophic questions which seemingly should not be resolved in tax legislation that, on net balance, has little to commend it on other grounds. If we are to change the basic nature of our American institutions, then we should debate and decide the issues on broad philosophic terms first, not move toward such objectives through the details of tax legislation promoted on other grounds.

I will now proceed to specific comments in regard to provisions of the legislation before you.

SECTION 2—CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

The proposed credit is a means for providing varying degrees of relief for some taxpayers but not for others. It is not in form or substance a part of, or in substitution for, or in addition to, or a companion of, depreciation reform. It would simply provide reduction in effective tax rates for taxpayers who use their income, or other funds, as the Government thinks is best for the economy at a particular time.

There has been a tendency to promote and discuss the investment tax credit apart from the price which it would exact in terms of other changes in the tax law. Even without the exaction of such a price, we would oppose the credit for the reasons set forth in the appendix attached hereto. Very simply, we believe that tax reduction should be afforded by direct means. We would take this position even if, in our opinion, all of the other provisions of H.R. 10650 constituted sound tax policy.

Consistently, we would not favor legislation of the character of H.R. 10650, even if the tax reduction feature were of the kind to which we subscribe. Despite any seeming temporary advantage, we do not believe that the reshuffling approach offers significant promise for the reduction of the tax burden on capital accumulation and use. Instead, as I have indicated, we look upon it as providing a green light for more Federal spending, which would tend to perpetuate or even increase the restraint of taxation on capital formation and economic progress. This is why we say that H.R. 10650 would provide a red light against adequate growth in the private economy. We believe that the whole approach reflected in H.R. 10650 should be abandoned and that instead the Government should turn to an alternative program of releasing the tax blocks to economic growth, combined with reduction and control of the spending level.

SECTION 3—EXPENSES, ETC., WITH RESPECT TO LEGISLATION

This section deals with the deduction of expenses in connection with the expression of business viewpoints on legislative matters, at all legislative levels. Such expressions are necessary to assure that laws do not impede or restrain the effective functioning of our private enterprise system. Consistently, expenses in connection with such expressions are "ordinary and necessary", and there is no stautory prohibition to the contrary. The present situation has been created by an interplay of administrative regulations, and court decisions, resulting from a failure of explicit statutory language on the subject.

The section as drafted, however, would draw a line through such expenses. It would permit generally the deduction of those which involve expressions directly communicated to legislative bodies, or members thereof. But it would deny deductions where expressions are designed to influence the general public, or segments thereof, in regard to legislative matters.

We appreciate the recognition which the Ways and Means Committee, on two occasions, and now the full House of Representatives, has given to this problem, but the provisions in H.R. 10650 do not come to grips with the full scope of the problem. To achieve an adequate resolution of the issue we urge consideration by this committee of the bill, S. 467, jointly sponsored by Senators Kerr and Hartke.

This bill would provide a comprehensive and equitable remedy by permitting the deductibility of legislative expenditures to the extent they would qualify as "ordinary and necessary" business expenses related to the business of the taxpayer and reasonable in amount. Clearly, the limitations indicated, as well as the discretionary authority left to the Internal Revenue Service, would provide adequate safeguards against possible abuse.

In light of the seriousness with which we view this problem, we propose to file a more extended statement of our views for inclusion in the record of these hearings.

SECTION 4—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

As stated earlier, the effect of this section would be to withdraw the protection of business judgment afforded by the "ordinary and necessary" rule of expense deduction.

In some respects, the new rules would be completely arbitrary, substituting statutory for business judgment as to what is an "ordinary and necessary" business expense. In other respects, the new rules would delegate to the Revenue Service arbitrary power to substitute its judgment for business judgment as to what constitutes "ordinary and necessary" business expenses.

Section 4 provides that no deduction is to be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement or recreation, except to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. The Ways and Means Committee report states that objective standards will be applied, first as to what constitutes such an activity and, second, whether the purpose of expenditure is directly related to the active conduct of a trade or business.

These are fair-sounding words, but they run counter to experience. The Supreme Court and many lower courts have confirmed this experience in recognizing the impossibility of formulating specific and precise guidelines in this area without subordinating business judgment to Government fiat, as stated by Justice Cardozo in *Welch* v. *Helvering:*

"One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all of its fullness must supply the answer to the riddle" (290 U.S. 111 (1933)).

The fact that specific guidelines will inevitably produce an arbitrary result, denying to some taxpayers the deduction of expenses which reflect the best of business judgment, is underlined by the repetitive process of proposal, review, and rejection of various formulas in the course of the Ways and Means Committee's considerations of the administration's recommendations. It may be taken for granted that close study of the provisions of section 4 as now drafted will show that their application will inevitably produce arbitrary and capricious results.

Specifically, under the first test, any activity which is not directly related to the conduct of a particular business seems to fall in the entertainment-type area, which includes amusement and recreation. Under the second test, expenditures for such type activities will not be deductible if the value to the business is collateral rather than direct. On page A29 of the Ways and Means Committee report a particularly illuminating example of this type of situation is given, as follows:

"Another example of the role played by the taxpayer's business is determining the type of an activity would be in connection with a fashion show. If the taxpayer conducting the fashion show is the manufacturer of the dresses shown and the viewers are a group of store buyers, the show generally would not be considered to constitute entertainment, because the fashion show is, for a dress manufacturer, a method for introducing his product to the market. However, if the taxpayer conducting the fashion show is an appliance distributor and the viewers are the retailers and their wives, the fashion show generally would be considered to constitute entertainment."

This illustration conjures the situation of a businessman considering two alternate promotion plans to increase his sales by a total of, say, $1 million. One plan calls for an expenditure of, say, $50,000 for local newspaper advertising. The other is an expenditure of $25,000 for putting on local entertainment-type promotions which his dealers argue might get equal or better results. The law would say that the latter is not a deductible expense.

The intention as indicated elsewhere in the committee's report, is to prohibit deduction where the value of an entertainment-type activity to the taxpayer is of an advertising or promotional nature. In effect, the bill, as interpreted by the report and illustrated, says: It matters not the value to the taxpayer's trade or business of the activity, if there is any fun or pleasure in connection with it, it won't be deductible.

It would seem that any legislation in this area necessarily would go further than preventing abuses in regard to entertainment and other business expenses. It inevitably would restrict or disallow such expenses, in cases in which there could be no question as to the good-faith application of business judgment. In

such cases, the taxpayer either would be inhibited from following his judgment or penalized to the extent of the applicable tax rate if he nevertheless incurred the affected expenditures.

The "ordinary and necssary" rule for determining deductibility of business expenses harmonizes tax law with business practices and accounting. It is an indispensable part of the computation of tax on net income. Restriction of the rule, regardless of the formulas used, would require payment of tax on something in excess of true income. This would be economic confiscation, regardless of whether the courts would find it legal confiscation. In harassing, penalizing, and confiscating income of the innocent, the proposals in this area make a sharp break from American traditions of fairness and justice.

Any legislation in this area will complicate rather than simplify the tax law, and compound rather than ease the problems of tax administration including audit.

To the extent that such legislative restrictions would prevent or inhibit business expenditures, which otherwise would be made, there would be an adverse effect on total business activity and hence on Federal revenues.

To the extent that they deny deduction of actual business expenses, they would have a comparable effect on business profits and capital supply. By and large, it may be assumed that the $125 million revenue effect estimated by the Treasury for these provisions would be reflected in comparable reduction in business net income.

We will file a more extended statement of our views on this subject in the record of these hearings.

(The extended statement of views on section 4referred to above appears at end of this prepared statement following the appendix.)

SECTION 8—MUTUAL SAVINGS BANKS, ETC.; SECTION 17—TAX TREATMENT OF COOPERATIVES AND PATRONS

The NAM has long and strongly advocated equal taxation of competing enterprises, regardless of the form of doing business.

Mutuals

The provisions of section 8 in regard to mutual savings banks and savings and loan associations fall short of full and equal taxation. The bill provides alternate methods for taxing these institutions, one of which would require payment of tax on only 55 percent of operating income, as compared with taxpayment by commercial banks on about 80 percent of operating income.

Cooperatives

In terms of competitive economics, there is no reason why the tax burden on cooperative income should be less than that on regular corporations.

At a minimum the earnings of cooperatives should be taxed once either to the cooperative corporation if it retains the use of beneficial enjoyment of the income for growth, or to the patron if the earnings are distributed in cash so that the patron may exercise full dominion and control thereover at the time received.

Section 19 imposes withholding on patronage dividends, and section 17 attempts to impose a single tax on co-op income by providing for a deduction on patronage dividends even if paid in so-called scrip, provided (1) the scrip can be converted into cash within 90 days at the option of the patron or (2) the patron has consented to include the amount of this scrip in his own income. This may be a written consent given directly by the patron and would remain in effect unless revoked.

Under a late revision of the bill by the Ways and Means Committee, cooperative member consent may also take the form of inclusion in the cooperative bylaws of a provision requiring patron members to pay tax on all such scrip. Under this arrangement, co-ops would retain earnings without taxation at the corporate rate since the patron would receive an allocated dividend subject to taxation at personal income tax rates, as if it had actually been distributed, while the funds—minus withholding—would remain with the co-op.

Industry had been hopeful that the provisions before the recent amendment would result in a substantial payout of cash by cooperatives to patron members or, as the alternative, that retained cash would be subject to full corporate tax rates. However, the provision for member consent through a provision in a cooperative's bylaws enhances the possibility that the bulk of cooperative earn-

ings would be retained as cash for growth purposes. Such cash retentions would be subject in effect to a 20-percent tax (the amount of withholding) as compared with the top 52-percent rate paid by regular corporations. This would provide continued encouragement for the expansion of cooperatives, at the expense of their full taxpaying competitors, and consequent further loss in Federal revenues. It is an inadequate resolution of the problem.

SECTION 19—WITHHOLDING ON INCOME TAX AT SOURCE ON INTEREST AND DIVIDENDS

Withholding on salaries and wages is workable and generally equitable because of the allowance made for exemptions and deductions.

Using the same benchmarks, withholding as regards interest and dividends is not workable and would be generally inequitable. It would be a hit-or-miss proposition. Whenever the amount of tax liability happened to approximate the amount withheld, the result would be accidental. Withholding is not adaptable to this area, unless there is no intention that the amount of tax withheld should be expected to generally approximate the amount of tax due.

Withholding would be extremely inequitable as regards great numbers of taxpayers whose tax liability is substantially less than the amount which would be withheld. No system of quick refunds could change this fact. The provision of the House bill permitting liberal use of exemptions where no tax liability is expected is adequate proof of this conclusion. There could be no material difference in the inequity of withholding at 20 percent in the case of a citizen who has no tax liability after exemptions and deductions, and in the case of one whose liability is only a small percent of the amount withheld. To avoid substantial overwithholding, it would be necessary to grant exemption certificates for all taxpayers who estimate that their tax liability is significantly below the amount which would otherwise be withheld.

Withholding on interest and dividends would add immense complexity and confusion to the administration of the tax laws. We could be sure that whatever the pattern of statutory provision and administrative regulation at the beginning, if withholding in this area should be instituted, there would be repetitive change and revision on a trial-and-error basis over the years.

In our opinion, and whatever the case for withholding on interest and dividends may have been heretofore, now is a most inopportune time to consider it.

Automatic data processing is scheduled for complete operation by 1966. The proposed withholding would first apply to the calendar year 1963. We cannot accept the statement that automatic data processing will prove efficient only in regard to unreported interest and dividend income of substantial amounts. Regardless of whether it is profitable to follow up all tax returns in regard to which ADP revealed, or could reveal, unreported interest or dividend income, the fact that ADP would provide the Government with the necessary evidence as to evasion would be a powerful inducement to honest reporting. It is strange that the possibilities in this connection are not given full opportunity, instead of being discounted in advance.

Actually, institution of withholding might do more to interfere with faithful reporting and payment of tax on interest and dividends than to achieve this result. Last fall, Commissioner Caplin on one or more occasions publicly encouraged taxpayers who are delinquent in reporting and paying tax on interest and dividends to "come clean." More recently, this kind of public encouragement seems to have been soft-pedaled in the interest of promoting the case for withholding. Certainly, the prospect of being caught by ADP, and the possibility that those who "come clean" before 1966 would be in better position than those who just get in under the deadline, should precipitate a maximum response to a continuing campaign of encouragement.

The anonymous character of withholding would enable any individual to escape detection by foregoing any claim to the 20 percent withheld from his interest or dividends. In other words, withholding is purely a revenue-collecting device, not only with no real regard to tax liability, but also one which cannot be expected to make a net contribution toward uncovering evasion in this area, or toward compliance with the law in the future.

Withholding on interest and dividends would convert growth capital into Government spending through the speedup in time when taxes legally due are actually paid. Furthermore, it would defeat the objective of savers in placing funds at the maximum rate of compound interest.

Repeal of the 4-percent dividend credit and $50 dividend exclusion

In his statement before this committee yesterday, Secretary of the Treasury Douglas Dillon again recommended repeal of the 4-percent dividend credit and $50 dividend exclusion. He estimates that the annual revenue gain from repeal would amount to $475 million.

Aside from the short-range expedient of gaining revenue, the Secretary repeats two points for repeal made last year before the Ways and Means Committee; namely:

(1) That the credit provides relatively greater tax relief to investors in high-income rather than in low-income brackets; and

(2) That the credit has been ineffective because "In the 8 years since (its adoption) the proportion of total corporate public long-term financing accounted for by stock issues has not been significantly higher than it was in the 8 years prior to 1955."

The first point is true only because of uneconomic tax rates. The argument could as well be made that all exemptions should be eliminated from the tax law because the dollar value of an exemption is greater in a high-income bracket than in a low-income bracket. It is past time to discontinue this kind of class-against-class tax talk, and give positive attention to the interest of citizens in the poorer income circumstances in greater capital formation and higher economic growth.

In regard to the second point, a table included in exhibit IV to the Secretary's statement shows an increase in average annual equity financing from $1.9 billion in the years 1946–53 to $3.3 billion in the years 1954–61. This is an average increase of $1.4 billion or 75 percent. This increase is approximately three times the estimated revenue effect of the credit and exclusion. Considering all factors, it would be reasonable to conclude that the amount invested in new corporate equities since 1954 would have been substantially less except for the credit and exclusion.

The factor which has been most discouraging in regard to equity financing has been a combined top corporate rate of 52 percent since 1954, as compared with a top rate of 38 percent between World War II and the Korean war. Stating this factor differently, if the corporate rate in recent years had been no higher than 38 percent, it would be reasonable to believe that corporations would have been less inclined to take advantage of the deductibility of interest, and more inclined to broaden the base of their equity ownership.

At the same time that the 52 percent corporate rate discouraged use of equity financing, it—combined with the wage-cost squeeze on profits—has forced corporations to seek greater external financing for expansion in plant and equipment. Under such pressures, it is somewhat surprising that they have not tended toward relatively greater recourse to debt financing.

Regardless of how much of the tax savings from the dividend credit and exclusion are directly invested in new corporate equities, the fact of stock ownership is proof of the saving and investing habit. Thus, it may be assumed that most of the tax savings from the credit and exclusion become new capital. Whether such capital is invested in equities, in corporate debt issues, or elsewhere, it becomes part of the total capital available for all uses in America. Repeal of the dividend credit and exclusion would eliminate this source of annual additions to total capital supply.

At a time when the national need for greater capital formation is so evident, and is in fact attested to by the administration's recognition of the connection between tax policy and economic growth, it is difficult to understand how there could be continued advocacy of the withdrawal or modification of tax provisions of particular importance to savers and investors or which otherwise contribute to the total volume of capital formation.

The way to begin reforming the tax structure to permit greater capital formation and economic growth certainly is not to take out of the structure provisions designed to serve that purpose.

Repeal of the dividend credit and exclusion would be a step backward in tax policy, reestablishing the full inequity of double taxation and reducing the annual increase in growth capital.

SECTIONS 5, 6, 7, 9, 13, 15, 16, 18, AND 21—TAXATION OF FOREIGN BUSINESS INCOME AND SO-CALLED TAX HAVEN OPERATIONS, ETC.

The proposals for altering time-honored rules for the taxation of business income earned abroad are said to be needed as a means for improving the present adverse balance of international payments. Such thinking is difficult to fathom,

Apparently, it stems from a very short-range view in regard to objectives to be achieved through changes in the tax structure; a view which is in sharp contrast with the long-range objectives of the administration's foreign trade program. Taking the two programs together, it seems that the administration is saying: "We want free trade, but slave capital." From an economic standpoint, freedom of capital could never fail to serve America's long-range economic interest.

There is no reason to believe that, on net balance, the provisions of H.R. 10650 requiring higher immediate taxation on foreign source income would have even a temporary, beneficial effect as regards the balance of international payments. It should be recognized that a typical American industrial corporation is neither just a domestic producer, nor just an exporter, nor just a foreign investor, but is a combination of all three. To assure the maximum American economic effort in all markets over the years ahead, and to build our economic strength and prestige in the world, short-range considerations should not be allowed to overrun long-range objectives.

Basic considerations

American business corporations invest abroad only because of the expectation of making profits for distribution to their shareholders at home. By and large, the profit expectation is not based on the original investment alone. Instead, it is expected that the first profits abroad will be reinvested, and that this process will continue in part as regards subsequent profits. It is these reinvested profits which in large part account for the return flow of income to shareholders, and revenue to the U.S. Government. Any action which serves to diminish the reinvestment of profits either will result in a reduced return flow of income at a subsequent time, or be matched by a greater immediate outflow of capital. When the building of capital abroad through reinvestment takes place in countries where tax rates are lower than ours, the need for export of American capital is relatively the lowest in order to accomplish given objectives in regard to production and markets.

Thus, it is apparent, that domestic tax policy which is most favorable as regards foreign investment will precipitate the maximum long-range return flow of income with a minimum outflow of capital.

Short-range effects

In 1961, income from direct foreign business investments totaled $2.4 billion, whereas direct new capital outflow amounted to only $1.6 billion. The indications are that these relationships are being approximately maintained in 1962.

In making the case for altering the historic tax rules for treatment of foreign business income, emphasis has been placed on the fact that the outward flow of capital to developed countries is greater than the return income flow, while the situation is reversed as regards the underdeveloped countries.

The assumptions that changes in the tax rules would, in the short range and in and of themselves, effect a significant change in this pattern, or increase the relation of return income flow to capital outflow, lack foundation.

First, in some situations, there undoubtedly would be some withdrawal of foreign earnings which otherwise would be used for reinvestment, in amount necessary to pay the additional taxes. To the extent which business judgment dictated, however, and funds were available, these withdrawals would soon be matched by comparable additions to outflow of capital. To the extent that this happened, there would be reduction in capital available for domestic investment, without change in the balance-of-payments situation.

Second, in many if not most situations, the disposition would be to pay the additional immediate tax liabilities out of domestic earnings of the parent corporation. In this event there also would be a reduction in capital supply for domestic use, without net affect on the balance-of-payments situation.

Long-range effects

To the extent that the short-range objects for forcing a greater current return income flow, and a reduced capital outflow, are not frustrated by the factors recounted above, there would be adverse effect on the long-range relation of capital outflow, and return flow of income. The latter would be less than otherwise would be expected, and the former might well be greater.

In the absence of adverse tax or other policies, it is to be expected that the spread between total outflow of capital and return flow of income will gradually increase over the years, and especially that the return flow from Western Europe

will by the mid-1960's to late 1960's overrun the capital outflow to that part of the world.

However, if the national policy of encouraging greater investment in the less developed countries should result in a greater flow of capital to those areas for manufacturing and distributive purposes, as contrasted to extraction of minerals, there would be a period of digestion in which the return income flow would not move upward as fast as the capital outflow.

Investment economics and the European Common Market

The capital which goes to Europe, or elsewhere, is not in lieu of domestic investment for production of goods intended in whole or in part for export. The purpose of foreign investment is to preserve or expand the market for goods and services of American enterprises. Such investments are made when it is good business to do so. Instead of being at the expense of exports, investment abroad creates markets for U.S.-made goods in two ways:

First, it provides an immediate market for U.S.-made producers' equipment, and subsequent markets for U.S.-made prefabrications and components; and

Second, consistent with the fact that the best markets for American goods are in the more developed areas of the world, the greater economic activity generated by American investments abroad expands the markets in foreign countries for U.S.-made goods.

It should not be believed that discouragement of investment in Western Europe at this time would be compensated for by a subsequent reversal of policy in this respect. The breadth and depth of American enterprise is still greater than that of any other country, or combination of countries. If we do not invest abroad while this situation exists, we would be forgoing a major opportunity to improve the long-range income inflow from investments. Especially, it is of the utmost importance that American investment be made in Western Europe in the formative years of its Common Market, before European companies preempt the best opportunities. This will provide the greatest return flow of income. There can be no question, looking back from, say, 1970, that American investments in Europe and elsewhere will have proven to be an increasingly favorable factor as regards the balance of international payments, not to mention our total position of economic strength and prestige in the world and vis-a-vis the Communists.

"Gross-up" not based on equity

The points made above provide a solid case against the application of so-called "gross-up." However, arguments which require attention have been made as regards the equities in this area.

First, the argument has been made that "gross-up" is necessary in order to create equity between American corporations conducting their foreign business operations through subsidiaries, on the one hand, and branches, on the other. Actually, many American corporations conduct some of their foreign operations through subsidiaries, and some through branches. However, the companies whose operations are wholly or mostly on a branch basis have not compained about the tax treatment of subsidiary operations. The fact, which has been often made but lost sight of, is that the nominal tax advantage of the subsidiary is often outweighed by other factors which benefit a branch operation, although such factors will vary from country to country. There are many factors other than taxes which influence a business decision to use a branch rather than a subsidiary operation, or vice versa.

Second, the argument is made that "gross-up" is necessary in order to create tax equity between American corporations engaged only in domestic operations, and those which also conduct foreign business operations.

There are several points to be made which make this thesis less tenable than would appear at first blush. The corporate income tax is only one of the taxes directly or indirectly borne out of business income, both at home and abroad. If all taxes were taken into account, in many cases instead of the apparent statistical equality when the foreign corporate rate is 52 percent, the total charge against the foreign income would be significantly greater than if the income had been derived within the United States.

Moreover, despite the uniform Federal top corporate tax rate, the total direct and indirect charges against income of American corporations will vary according to its exposure to State and local taxes as well as other Federal taxes.

In other words, there is no reason to believe that, if "gross-up" were enacted, there would be greater effective tax equality as between different corporations

than there is at present. In fact, the overall tax discrimination now existing against foreign subsidiaries in many cases would be compounded. Certainly, the national interest in preserving the existing tax treatment of foreign business income is greater than any case which can be made for "gross-up" on the basis of statistical apparencies.

So-called tax haven misunderstood

The provisions designed to impose immediate income tax on U.S. corporate shareholders of so-called tax-haven companies, are contrary to the national interest. They do not reflect understanding of the national benefits which result from maximization of profits in such companies and the free use of those profits in further foreign investment.

As stated earlier, the efforts to impose tax on unrepatriated business income would establish a dangerous precedent for disregarding corporate entities in the imposition of tax. Apart from the implications of such a precedent, the provision in question should not be enacted, for the following reasons:

(*a*) The transaction of business abroad through foreign operating companies is essential in order to maintain the world competitive position of American-owned enterprises. The existing tax treatment of income from such companies has been an integral part of our tax structure since the beginning of the income tax, and is in no sense a loophole.

(*b*) The location of such foreign operating companies in low-tax countries provides definite advantage as regards the balance-of-payments situation, because reinvested profits will be greater than in high-tax countries and the outward flow of new capital from America will thus be less. The purpose of locating in such countries is to minimize the burden of foreign tax, not of the U.S. tax. By minimizing foreign tax, and reinvesting profits, the greatest long-range return flow of income to the United States will be produced. This in turn will maximize the U.S. tax revenue over the same years.

(*c*) The fact that serious constitutional questions are raised whether the U.S. income tax can reach undistributed operating income of foreign corporations is, in and of itself, a major reason for rejecting the provisions.

(*d*) These provisions are extremely complex and, if enacted, would impose formidable administrative burdens upon both the taxpayer and the Government. This complexity is inherent, and while some improvements might be made in the provisions, there are no improvements which would change their fundamental character.

(*e*) The U.S. Treasury Department already possesses powerful weapons to deal with such abuses of so-called tax-haven companies as may be assumed to exist. These include the right to construe transactions according to their economic substance, rather than their legal form; and the right to allocate income and expense between entities on the basis of economic realities. We would caution however, against the exercise of this right where the result would be to increase current U.S. tax at the expense of maximization of reinvestment of profits abroad.

EFFECT OF H.R. 10650 ON CAPITAL SUPPLY AND USE

Under the provisions of H.R. 10650, American manufacturing companies as a whole would receive much more tax reduction through the investment tax credit than they would lose from the revenue-gaining provisions of the bill. Such a pragmatic benchmark of self-interest, however, is not appropriate to this kind of legislation for a number of reasons:

1. The overall and subsidiary objectives of the legislation, as summarized on pages 5 and 6 of this statement, are inimical to sound tax policy and the most effective functioning of our free economy over the years.

2. The welfare of a business corporation cannot be considered apart from the welfare of its owners, its creditors, its employees, and its customers.

3. In looking ahead to tomorrow's markets and profits, manufacturers could hardly expect that they would gain from any continuing program of shifting of tax dollars from one pocket to another.

4. In the total economic sense, the important thing to our Nation's economy, and hence to manufacturing companies, is the total volume of capital which is available to serve the purposes of progress. As much as we believe that the national interest would be served by diminishing the tax burden on corporate profits, we also know that this interest would be equally served by increasing the quantity of new, mobile venture capital in the hands of individuals. Because

of steeply progressive rates of tax on individual incomes, on estates and gifts, and of the taxation of gains on investment switches, the shortage of venture capital has been and continues to be one of the most critical factors in our economy since World War II. We would not want to compound this problem by a tax-reshuffling process.

5. In the ultimate economic sense, the value for economic progress of H.R. 10650 must be determined on the basis of its effect on total capital supply, regardless of whether particular provisions or objectives of the legislation are otherwise compatible with the public interest and equitable in nature. More specifically, additional taxation of mutual savings banks and insurance companies, and cooperatives, would have the immediate effect of diminishing capital available through these channels.

6. Despite claims to the contrary, there is no reason to believe that the effect on capital formation of an investment tax credit would be any greater than would result from the release of a comparable number of tax dollars through tax-rate reduction. A company would be just as free to remit to owners part of the tax savings from such a credit as it would be in regard to the tax savings from a rate reduction. It is much easier to bring the issues involved in H.R. 10650 into proper focus when this simple fact is recognized.

7. Including the recommended repeal of the 4-percent dividend credit and $50 exclusion, a large part of the revenue gain from H.R. 10650 would amount to a subtraction from established capital in the hands of individuals. Corporate income taken by the revenue-gaining provisions of the bill would, except for the new taxation, be exposed to the same alternatives of reinvestment or remittal to owners as would apply to tax savings under an investment tax credit or tax-rate reduction. When the effect on retained earnings of cooperatives and mutuals is added to this picture, it is clear that H.R. 10650 could not conceivably make an addition to net capital supply, but, more likely, would result in reduction thereof.

8. Since greater economic growth, the provision of new and better jobs, greater advance in living standards, and greater national strength and security, are dependent upon the release of capital from taxation, it is improper to claim that H.R. 10650 would make any net contribution in this respect.

ALTERNATIVE TAX AND FISCAL POLICY

In its recognition of the connection between tax policy and capital formation, economic growth and job creation, the administration has set the stage for searching inquiry on a subject critical to the Nation's future. Unfortunately, H.R. 10650, or any other legislative application for the reshuffling theory embodied therein, would be ineffective in regard to growth and jobs. The problem remains, but it is clear that its resolution can be found only in some alternate approach to the tax and fiscal problems.

The alternate approach necessarily should be designed to provide a green light for faster growth in the private economy, and a red light against further uncontrolled Federal spending.

One of the misconceptions on the American scene is that we always have enough capital; perhaps too much at times. Nothing could be further from the truth. There is no such thing as too much capital; there is no such thing as idle capital. When more capital is accumulated, it will be used.

Consistently, whatever restrains the accumulation of capital, whatever destroys capital once accumulated, limits economic growth. The more capital that is accumulated in any nation, the greater will be its progress.

As cited earlier in this statement, the new study by Mr. Kuznets buttons down the fact that Government spending and taxing policies are the root cause of inadequate capital formation and economic growth over recent years.

On the one hand, uneconomic tax rates and methods restrict capital accumulation and destroy capital once accumulated.

On the other, the Government continues to use for increased spending on new and old programs revenue which should be retained in the private economy through reform of tax rates and methods.

To serve the national interest, it would be necessary to reverse these policies. This would mean, on the one hand, inauguration of an orderly plan for moderation of the tax rates and methods which restrict capital accumulation and destroy capital once accumulated, and, on the other, forbearance by the Government from spending on new and old programs the revenue which the reform of uneconomic tax rates and methods would leave in the private economy.

There are five major tax blocks to high-rate, long-range economic growth, namely:

Steeply graduated individual tax rates.
Excessive top rate of corporate tax.
Unrealistic length of lives and classification of depreciable property.
Taxing of gains on transfers from one investment to another.
Destructive rates of estate and gift taxes.

Reform of these rates and methods would open the way toward reinstating the American economy as the most dynamic in the world. Such reform would provide new opportunity to prove that capital in a free society is more productive of good for more people than under any other system.

Three years ago, two members of the House Ways and Means Committee, Representatives A. S. Herlong, Jr., of Florida, and Howard H. Baker, of Tennessee, introduced legislation to accomplish such reform. This original bill has been introduced in the Senate (S. 2932) by Senator Tower, of Texas. During its recent deliberations on the administration's tax program, as now embodied in H.R. 10650, the Ways and Means Committee tabled a motion to report out the Herlong-Baker legislation by a vote of 14 to 11. In making his motion, Representative Herlong advanced the effective dates of the legislation, and proposed a substitution for the provision in regard to depreciation reform. The manner in which this legislation would reform tax rates and methods which restrain economic progress may be briefly summarized:

Personal income tax

THE PROBLEM	THE SOLUTION
The ruthless graduation chokes off venture capital at its source, discourages risk taking, smothers incentives, curtails business starts and expansion, prevents job creation, and is the major deterrent to adequate long-term economic growth.	Over a 5-year period the rates would be stringently compressed with the top rate reduced to 47 percent and the other graduated rates lowered in a consistent pattern.
It is the scourge of small business and of the man on the ladder.	Every personal taxpayer would get a minimum reduction of 25 percent, with the first rate reduced to 15 percent.
By exacting stiff penalties on hard work and long hours, graduation is in direct conflict with the universally accepted principle of reward for extra effort and achievement.	On the principle that no unincorporated business, professional person, or other individual taxpayer should pay a higher tax rate than a corporation, the new top of 47 percent would be the same as that on corporate income.
Rates top out at 91 percent and hit 50 percent at $16,000 of taxable income from a start of 20 percent.	

Corporate income tax and depreciation

THE PROBLEM	THE SOLUTION
The excessive top rate severely limits retained earnings, an important source of business expansion and job creation.	Five annual reductions of 1 percentage point each would be made, bringing the top corporate rate down to 47 percent and the first rate to 27 percent. For depreciation purposes the required time for writing off new property would be reduced by 25 percent on the average.
The tax takes 30 percent of profits up to $25,000 and 52 percent above that. More of current business income, incorporated and unincorporated, is subject to excessive tax rates because of continued requirement of depreciation allowances based on length of property lives which are unrealistically long in this period of rapid technological change.	On top of the double declining balance and sum-of-the-years-digits methods established by the 1954 code revisions this would mean a 33-percent increase in the rate of property writeoff. The legislation would also substitute broad property groupings for present detailed classifications, providing greatest depreciation relief where taxpayers are most unfairly treated.

Capital gains—estate and gift taxes

THE PROBLEM	THE SOLUTION
The tax on capital gains converts capital into current Government spending whenever an asset is sold at a gain.	Following the rollover principle applied on the sale and repurchase of homes, the tax on long-term capital gains for individuals would be deferred until the taxpayer fails to reinvest the proceeds from the sale of affected property. To qualify for deferral, transfers between investments would have to take place within the same taxable year.
Estate and gift taxes also result in conversion of accumulated capital to Government use. Capital taxed away must be replaced by new savings out of current income before there is any net addition to capital supply.	
In penalizing the movement of capital the capital gains tax also discriminates against new, risky, job-creating enterprises. The maximum long-term capital gains rate is 25 percent; the taxes on estates go from 3 percent to 77 percent; those on gifts from 2.25 percent to 57.75 percent.	The top rate of the estate tax would be reduced to 47 percent, the top gift tax rate to 35.25 percent, and all lower rates of both taxes would be reduced in proportion.

In a recent letter to organizations supporting the Herlong-Baker legislation, Representative Herlong provided some estimates in regard to the revenue cost of effectuation in fiscal year 1963, and also in regard to depreciation alone over a period of several years, as follows:

"On the assumption that enactment of H.R. 2030 as encompassed in my motion would so influence the economy as to result in a gross national product of $570 billion in calendar year 1963, we estimated that total budget receipts would be $90.4 billion in fiscal year 1963. In the absence of enactment of H.R. 2030, we estimated that gross national product in calendar year 1963 would not exceed $560 billion and that revenue in fiscal year 1963 would total $92.3 billion. If, because of enactment of H.R. 2030, Federal expenditures in fiscal year 1963 were held $1.9 billion below those to be expected upon continuation of current trends, then it would be accurate to say that enactment of this legislation would have no adverse effects as regards the total budget picture for fiscal year 1963—while adding $10 billion to the total goods and services provided by our economy.

"Our estimates of the revenue effect of depreciation reform contemplated in the substitute for section 6 are $400 million in fiscal year 1963, $1.1 billion in fiscal year 1964, and $1.6 billion in fiscal year 1965, with only moderate further step-ups in revenue effect in a few succeeding fiscal years."

By enacting this legislation, Congress would be setting the general public interest in greater economic growth above all other domestic considerations.

The public interest in control of competitive spending would be enforced by a provision requiring postponement of forward-scheduled rate reductions when budget unbalance is threatened. This provision would pose a clear choice for the executive branch, and the Congress, each year. If together these branches of Government did not apply a red light against increased spending, the private economy would suffer by postponement of the up-coming rate reductions.

In view of the failure to control the upsweep in Federal spending through other means, the Herlong-Baker legislation would be worth a try if fiscal integrity were its only goal.

As the economy responded in greater economic growth from more moderate tax rates, there would be consistent enlargement of the Federal tax base and soon a greater and steadier revenue flow than could be expected under present tax and fiscal policies.

APPENDIX—INVESTMENT TAX CREDIT

1. *Nature of credit.*—In the administration's advocacy of an investment tax credit, there has been a persistent tendency to view it as being a part of, or in substitution for, or addition to, or as a companion of, depreciation reform.

Actually, such a credit, in form or in substance, has no connection with depreciation reform. Instead, it is in form and in substance simply a means for lowering effective tax rates to the extent of qualification. The result would be to increase the effective graduation of the corporate tax, and also the personal tax as applied to the income of unincorporated businesses.

2. *Subsidy.*—In economic substance, the investment tax credit would be a subsidy. This fact was first stated by an administration spokesman in March 1961. As a subsidy, it is essentially an expenditure program. Its effect would be no different from establishing a Federal agency for the purpose of paying subsidies to businesses at the rate of $8 ($7 in H.R. 10650) for each $100 of expenditure for specified types of property.

3. *Carrot or stick.*—As between businesses which do or do not, or could or could not, take advantage of such a credit, or which do so in varying degree, the credit is as much a tax penalty as it is a tax favor. The objective could be as well achieved by reducing business tax rates and then applying penalty superrates for failure to reinvest in given property categories in varying proportion to profits.

This is only to say that tax manipulation of the economy is a two-edged sword. Favoring and penalizing by taxation are actually one and the same thing. The abortive undistributed profits tax of 1936 placed the emphasis on penalizing, but, as against those penalized, the result would have been to favor those who conformed to the Government-desired pattern of economic action.

Whether the carrot or the stick is used, the end result of this kind of device is the same. Those who do what the Government wants done at a particular time are favored, and those who for whatever reason do not are penalized.

4. *Economic effect.*—Despite its subsidy nature, there is no reason to believe that an investment tax credit would make any greater contribution to sustained, long-range economic growth than would result from release to business through orthodox means of a comparable amount of tax dollars, for the following reasons:

(*a*) If the administration had stayed with its original implication of a short-term, "stimulative" device, there may have been some tendency for business to move forward its plans for expenditure in affected categories in order to get sure advantage of the credit. When the administration shifted to an all-out context of permanency, it eliminated the reason for moving expenditures forward. The fact that the word "stimulation," with its short-term or temporary, artificial meaning, is still used in advocating the credit, does not impart character to the credit that does not otherwise exist. Reference to "stimulation" of long-term economic growth is an incongruity.

(*b*) Regardless of the short-term or long-term nature of the credit, however, or the semantics used in promoting it, it could have no more effect than the tax dollars involved except as (i) business diverted funds from other uses to expenditure for affected categories of property, or (ii) makes more use of bank credit than otherwise would be the case.

In a short-range context, it might be that a credit would excite business to make somewhat greater use of bank credit than otherwise would be the case. However, such an excitement could not be given effect for long, unless the Nation were to accept a continually inflationary expansion of bank credit, or credit were to be diverted from other uses. When the economy achieves full recovery, we inevitably will be faced with a new period of financial tightness. Under such conditions, there is no reason to believe that an investment credit would affect the natural allocation of funds based on rate of interest.

It seems to be believed in some quarters that more liberal use of bank credit is a substitute for the savings of individuals and business. Quite the opposite is true. The greater the total of savings, the greater the use that can be made of bank credit without inflationary consequences. The smaller the total of savings, the less the bank credit which may be used without inflationary consequences.

(*c*) Businesses which receive the advantage of a credit would be just as free to use the dollars so gained in disbursements to owners, or for kinds of

expenditure not qualifying for the credit, as they would be to so use tax reduction dollars made available through other means. There is no reason to believe that the use of business funds after enactment of the credit would to any significant extent overrule normal business judgment as to the best use of such funds.

5. *Foreign experience.*—England is often cited as one of the nations which employs an investment tax credit. Such nations as Germany, France, and Italy, with their faster moving and more stable economies, do not employ such a device. The credit in England covers plant as well as productive equipment. The credit has not solved their problem of an uneconomic tax structure, and it is hardly to be expected that it would solve ours.

6. *The basic tax problem.*—Except for the excessive and uneconomic use of tax rates and methods, there would be no reason to advocate an investment tax credit. In view of the need in the national interest to remove the tax blocks to greater economic growth, it is unfortunate that nearly a year has now been taken in discussion of a device that runs around the problem instead of meeting it. The public welfare will suffer further if consideration of this device continues to becloud tax discussions.

7. *Principle of credit.*—Though less complicated and manipulative than the original credit proposed, the flat credit is no different in basic principle. As would be expected, some of the testimony against the credit in the 1961 hearings was primarily directed at the complications of the then-pending proposal. But a great part if not the bulk of the testimony reflected opposition or dissatisfaction with the credit principle itself.

SUPPLEMENTAL STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS, BEFORE THE SENATE COMMITTEE ON FINANCE, ON SECTION 4 OF H.R. 10650 ON TAX DISALLOWANCES OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

The administration has urged elimination of so-called abuses in connection with certain travel and entertainment expenses. The House Committee on Ways and Means, after extensive hearings and reviewing the problems for many months, reported:

"The committee agrees that abuses in this or any other area of the tax law should not be tolerated, but it does not believe that the complete disallowance of such expenses, as recommended by the President, is the proper solution to the problem" (H. Rept. 1447, 87th Cong., 2d sess.).

We agree that abuses should not be tolerated but we respectfully submit that the proposal before you is not appropriate for dealing with problems that may exist in this area.

Since its inception, the Internal Revenue Code has provided for a deduction from gross income of expenses "ordinary and necessary" to the conduct of a trade or business. What appropriately constitutes such expense has been the subject of extensive litigation and administrative definition. The Supreme Court of the United States, and many lower courts, recognize it is almost impossible to formulate specific and precise guidelines in this area because of the necessity for exercise of business judgment, in light of various business circumstances, which must primarily be relied on to determine the propriety, for tax purposes, of business expenses. As stated by Mr. Justice Cardozo in *Welch* v. *Helvering:*

"One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle" (290 U.S. 111 (1933)).

The proposal under consideration runs contrary to this sound principle. To us it is a gross distortion of our tax philosophy to seek to substitute the subjective judgment of Government for the business judgment of a taxpayer responsible for a business enterprise.

Our tax system is based upon a policy of self-assessment which must be coupled with a full recognition of the principle of taxation of net income. The tax on profits from business activities is to be directed only to such net income as is determined under realistic economic and accounting principles. Net income can only be arrived at by recognizing all lawful costs and expenses which, in the judgment of the business taxpayer, are necessary to produce or assist in producing the income of the business. Departure from these fundamental concepts would shift our tax system from a net income principle to a gross receipts tax

principle, or a gross receipts tax less only those items of expense which, in the judgment of a Government official, are "ordinary and necessary" for the conduct of a trade or business.

In recent years, there has been a great deal of publicity on so-called abuses in the area of travel and entertainment expenses. Abuses no doubt exist, but we respectfully submit that the better manner in which to deal with them is through sound and realistic enforcement policies rather than adoption of statutory straitjackets which contravene the basic precepts of our tax system.

We would take exception to the views presented to this committee by the Treasury Department in testimony of April 2, 1962. Secretary Dillon indicated that tighter enforcement of present law is not the answer to the problem. He further notes, "Only clear-cut decisive legislation will remedy this ever-worsening situation, with its unfortunate effects on the morale of the general taxpayer and on tax revenues." We respectfully submit (1) the legislation proposed by the Treasury Department is not clear cut and decisive; (2) such an ambiguous legislative proposal will remedy nothing but will only serve to compound confusion; (3) the "situation," if one of any consequence exists, is not "ever worsening" but is being remedied through various enforcement programs and taxpayer scrutiny; (4) the superimposing of Government hindsight judgment on the business activities of a taxpayer will certainly have unfortunate effects on taxpayer morale and can serve only to foment controversy and break down the self-assessment system; and (5) whereas the Secretary indicates that there would be a net revenue gain to the Government of several hundred million dollars, many experts have questioned whether there would be any net revenue gain because of the impact the proposed restrictive legislation would have on many segments of the economy.

The Treasury Department, in its recommendations regarding this type of business expense, appears to overlook several basic facts of the present tax law. At the outset, the burden of proof for deductions from gross income always lies with the taxpayer. Thus, the proposal at hand would not change the basic burden of proof but merely substitute arbitrary rules or Government discretion in connection with lawful and legitimate business expenses. There is a wealth and abundance of law in the form of regulations, rulings, and court cases which, over the years, have recognized and yet restricted and defined the type of expense which will be considered deductible for tax purposes.

Beginning in 1960, the Treasury Department substantially modified the various return forms having to do with return of income for corporations, partnerships, and individuals. Under schedule E of form 1120, the 1961 corporation income tax return, item 7, specifically requires that expense account allowances of corporate officers be shown in total amount, as well as the amount of compensation which is called for under item 6 of this schedule. Item O of the same form 1120, contains a series of questions which must be answered having to do with the claiming of a deduction for expenses in connection with the hunting lodge, yacht, resort, or the leasing or ownership of hotel rooms or apartments, and the attendance of employees' families at conventions or business meetings. Thus, the type of detail which must be indicated on this return form provides a sufficient indication of trouble areas, if any exist, for detailed audit and inquiry.

The reaction of experts to the proposals advanced by the Treasury Department, both before this committee and the House of Representatives, have been spread upon the public record. In November and December of 1959, the Committee on Ways and Means of the House of Representatives conducted extensive panel discussions on the factor of business expense deductions and the general consensus of the experts testifying was that the present law was adequate to deal with this issue.

An essential element that seems to be lost sight of is that business enterprises are in business to make a profit. The reponsibility and judgment for the generation of such profit must be accompanied by the right to exercise discretion and authority. The professional managers of companies are accountable to the board of directors, the board of directors, in turn, is fully accountable to the stockholders and the stockholders will continue to risk their money in the business venture only so long as the business is prudently managed. Thus, the system of checks and balances built into business enterprises with the operation of the law and the demanding burden of proof required under such tax law, make the addition of further unrealistic statutory requirements a form of harassment that should not be condoned.

ANALYSIS OF SECTION 4

Section 4 of H.R. 10650 proposes to create a new Internal Revenue Code section 274 which provides for a disallowance of certain entertainment and business expense deductions, subject to enumerated exceptions and qualifications. No deduction would be permitted for an activity of a type "generally considered to constitute entertainment, amusement, or recreation," unless such activity is "directly related" to the active conduct of a trade or business.

There are no statutory criteria as to what is meant by such an activity nor by whom it is to be generally considered entertainment, etc. The report filed by the Committee on Ways and Means (H. Rept. No. 1447, 87th Cong., 2d sess.) indicates that objective tests are to be used in determining this issue. We contend, however, that the vague and ambiguous statutory criteria, in practical application, will result in a subjective—and hindsight—test with consequent uneven enforcement based upon personal predilections of the various revenue agents.

The bill would also propose that expenses for the use of a "facility" for entertainment, amusement and recreation will be disallowed unless the taxpayer can establish that the facility was used "primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such business." Again, the use of statutory terms such as "primarily" and "directly related" do not lend themselves to fair, even-handed enforcement nor do they provide adequate criteria for the guidance of the Government, as well as taxpayers.

In order for a taxpayer to fully comply with the undefined requirements of such a proposal, it would become necessary to maintain extensive records and files for the sole purpose of attempting to establish a direct relationship between an activity and the conduct of the taxpayer's business. The same would be true with respect to the maintenance of facilities of this type for it would be necessary to show that the use was primarily for the furtherance of the business or else face the prospects of having the expense disallowed in its entirety. Notwithstanding keeping such detailed records, the taxpayer would still be subject to hindsight judgment as to the propriety of the expense.

The blanket proscription against permitting a tax deduction for business gifts in excess of an arbitrary dollar amount is equally unrealistic. The giving of gifts to individuals with whom one does business is well established in the fabric of our economic society. The propriety of giving such gifts, regardless of the amount involved, must be based upon the sound judgment of the donor. Again, taxpayers will be required to keep elaborate records and engage in extensive bookeeping merely to keep track of what gifts have been given to what individuals by the taxpayer during the course of the year because of the limitation of $25 per gift per year per recipient. It does not take much exercise of the imagination to visualize the complexities of this problem in the instance of large companies and the extent of internal costs of bookkeeping required merely to keep track of this insignificant item. This additional burden on taxpayers, with no resulting revenue gain, is an illustration of the unsound tax philosophy underlying this proposal.

Paragraph (c) of section 4 of the bill is designed and intended to overrule the so-called Cohan principle. This rule of tax law was derived from the case of *Cohan* v. *Commissioner* (39 F. 2d 540 (C.A. 2d, 1930)) which held that deductible expenses, not otherwise substantiated, could be approximated by the taxpayer. However, this rule was further limited by the caveat of the court that taxpayers will not be premitted to unduly benefit from this right of approximation as the law would not condone tax deductions by a taxpayer where the "inexactitude is of his own making." Thus, the Cohan rule affirms that the basic burden of proof of justifying a deduction does not shift from the taxpayer but that approximations in respect of detail will be permitted, provided the business character of the expense and other elements, can be adequatedly substantiated. This principle was subsequently defined in some detail in Rev. Rul. 54–195, C.B. 1954–1, p. 47.

It is interesting to note that in the "Study on Entertainment Expenses" filed as exhibit V by Treasury Secretary Dillon as a part of his testimony of April 2, 1962, at page 10, the Internal Revenue Service Commissioner notes that the rule in the *Cohan* case is "basically equitable" but has caused administrative problems. It would appear unsound in principle and inconsistent argument that a rule of law which has stood the test of time for almost a quarter of a century and which is deemed basically equitable should be overruled because of admin-

istrative problems which will, without question, continue to exist regardless of the form of the statute. We submit that the Cohan rule is not the blank check for abuses that the Treasury Department seems to indicate. Moreover, the abolition of the rule would probably generate more controversies than it would settle.

Seemingly in tacit recognition of the inequities proposed under the bill, paragraph (d) of section 4 would create nine separate categories of exceptions to the general rule of disallowance set forth under paragraph (a) of the proposed new section 274. The first of these exceptions has to do with allowing expenses for food and beverages. However, such allowance is qualified and conditioned by requiring a judgment after taking into account "the surroundings in which furnished, the taxpayer's trade, business, or income producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverage are furnished" and that they must be of a type "generally considered to be conducive to a business discussion."

This series of ambiguous and nebulous phrases will contribute nothing to the effective enforcement of our tax laws or respond to the primary motivation of such tax laws which is the production of revenue. Who is going to make the ultimate objective determination as to whether surroundings in which meals are consumed and the taxpayer's business are sufficiently related so that they can be generally considered as conducive to business discussions. Such a series of undefined and undefinable criteria serve only to foment litigation and make realistic application of our tax laws a sham. Again, subjective rather than objective tests will be applied and a taxpayer would proceed at his peril in making expenditures of this type under such a statute.

We recognize that effective implementation and administration of the tax laws requires that a degree of administrative judgment be permitted. However, it seems inappropriate to best by statute the degree of latitude, interpretative powers and regulatory authority such as would be given to the Secretary of the Treasury under paragraph (g) of section 4 of this bill. Such delegation of blanket authority is particularly unrealistic and unsound when the underlying statute is patently replete with vague, ambiguous, uncertain, and undefinable terms. Experience and the volume of litigation demonstrates that the combination of a vague statute and undue delegation of regulatory authority results in the distortion of congressional intent and purposes and a multiplicity of taxpayer controversies and litigation with the Government.

H.R. 10650 would also amend section 162(a)(2) of the present Internal Revenue Code by deleting the deduction for the "entire amount expended for meals and lodging" in connection with travel expenses and providing instead that a deduction would be permitted only for a "reasonable allowance for amounts expended for meals or lodging" while in a travel status. Thus, there is a shift from permitting by statute a deduction for the entire amount of expenses to the use of the ambiguous standard of "reasonable allowance." This change of concept is unwarranted and can only lead to restrictive interpretation and possible arbitrary monetary limitations, such as have been previously proposed by the Treasury Department. No reason is given for this marked change of approach, other than to indicate in the report of the Committee on Ways and Means that this is the position taken in the Treasury Department regulation.

During the consideration of H.R. 10650 by the House of Representatives, Chairman Wilbur Mills indicated in the course of debate that the criteria which were to be considered in applying this vague standard are to be the locality in which travel is performed, the customary and usual standard of living of the person traveling, the purpose of the travel "and the relationship the travel expense bears to the anticipated benefit to the taxpayer's business." Such criteria are as vague and indefinite as the reasonable allowance principle and would contribute nothing to a realistic administration of such a statute nor provide any effective guides for taxpayers. Subjective determinations of whether a travel expense bears an appropriate relationship to an anticipated benefit to a taxpayer's business is a factor that should not be made the subject of Government judgment but should remain the judgment of the taxpayer businessman. This impresses us as regulating for the sake of regulation.

CONCLUSION

The ordinary and necessary rule for determining tax deductibility of business expenses has proven, over the years, that it harmonizes with sound business practices and accounting. It is an indispensable part of the computation of tax

on net income. To arbitrarily restrict the application of this rule would be to change long-standing concepts of business net income for tax purposes and substitute Government fiat for business discretion. Moreover, to the extent that such unrealistic legislative restrictions prevent or inhibit legitimate business expenditures which might otherwise be made, there would be a resulting adverse effect on total business activity, with the resulting impact on the Federal revenues.

The legislative proposals in this area appear to be motivated by what some contend to be a social evil of the expense account economy. If such evil exists, the law is presently adequate to deal with the problem. There is not much justification for burning the house down because there is a hole in the screen. We respectfully urge that the Congress not distort our basic concepts of net income taxation by creating arbitrary standards and limitations which make the income tax law a moral code rather than a means of producing revenue for the maintenance of the necessary services of Government.

The CHAIRMAN. The next witness is Mr. Leslie Mills of the American Institute of Certified Public Accountants.

Mr. Mills, you take a seat and you may proceed.

STATEMENT OF LESLIE MILLS, CHAIRMAN, COMMITTEE OF FEDERAL TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. MILLS. Mr. Chairman, my name is Leslie Mills. I am chairman of the Committee on Federal Taxation of the American Institute of Certified Public Accountants.

The American Institute of CPA's is the national professional organization of practicing CPA's in this country. It has over 43,000 members, and the committee on Federal taxation, of which I am chairman, is a large committee with representatives from all over the country, rendering professional services to all kinds of American business, large and small. Because of the limited time we have had for study of the Revenue Act of 1962, I would like permission to submit within a few days a detailed analysis of the major sections of the bill. We shall expand on my comments today and make observations.

(The supplemental statement referred to appears at the end of Mr. Mills' oral presentation.)

Mr. MILLS. I can thus conserve the time of the committee by emphasizing in my presentation now particular aspects of some of the major provisions which cause us concern. Our detailed statement will expand on my comments today, and in particular will present our observations on what appear to us to be technical deficiencies in the bill, with suggestions for improvements.

SECTION 2

I would like to comment first on section 2, providing a credit for investment in certain depreciable property.

In testimony before the Ways and Means Committee last May for my committee I expressed opposition to the credit in the form proposed in the President's tax message. Our objection was based, in part, on the belief that the proposals were unnecessarily complicated, erratic in application, difficult to apply, and presented so many problems of administration that the already complex tax structure would be further complicated.

It is our opinion that the investment tax credit as set forth in H.R. 10650 is a satisfactory version of an allowance for stimulation of growth in investment and productive plant and equipment. It should be recognized that the tax credit is in no way a substitute for overall reform of depreciation policies and practices, and that your committee will recognize that its enactment should not be taken by the Treasury Department as justification for delay in its announced program for depreciation reform and recognition of the inadequacy of present depreciation practices.

With respect to the related section 14, gains from disposition of certain depreciable property, we have been on record for some years that the statute should be amended to limit the capital gains classification of dispositions of such property. Such limitation should not, however, fail to recognize that under some circumstances such gains do not reflect recovery of excessive depreciation, but rather are the result of inflation and decline in the value of the dollar. More important, we believe that adoption of section 14 should be on the basis that it is a part of overall depreciation reform, which we think is the most important opportunity for stimulation of investment in new plant facilities.

SECTION 4

With respect to section 4, disallowance of certain entertainment, etc., expenses, we share the concern of the Treasury Department as to abuses which have become evident in this area. However, after careful consideration, we believe that legislative revision of the scope proposed is neither necessary nor desirable, and that continuation of the present very evident increased enforcement activities of the Internal Revenue Service, together with revision of the rules for substantiation of expenses, will solve the problem. The administrative problems under present law are admittedly difficult, but most taxpayers and the Internal Revenue Service are finding that they are not insoluble, and we believe that the difficulties would be enhanced rather than reduced by the new conceptual proposals before you.

Corrective legislation should not be the occasion for creating structural flaws that deal unfairly with business taxpayers or discriminate among taxpayer groups. The bill in its present form contains substantial elements of discrimination, especially against small taxpayers. The proposed prohibition against entertainment activity not "directly related to the active conduct of the taxpayer's trade or business" will prevent much of the activity that the small taxpayer uses legitimately in business furtherance and development. This prohibition is less significant to the large, well-established taxpayer. In addition, the exceptions to the prohibition tend to operate in favor of the larger business; some of the exceptions relieve larger businesses of possible nondeductibility of expenditures that the average small business is not able to afford. To the extent that taxpayers would be forced to pay entertainment expenses out of capital funds, instead of as deductions from income, the small and inadequately capitalized company would be seriously handicapped.

With respect to the substantiation requirement, we recognize that the present court-made rule has presented a difficult administrative obstacle to the Internal Revenue Service and we recommend that the force of the rule be eliminated.

At the same time it should be recognized that the rule stemmed originally from the difficulties of substantiation in an area where recordkeeping tends to be burdensome and inexact. The elimination of the rule should not be in terms that create a burden greater than that in existence before the rule was established. Where a taxpayer's record for expenditures might not be adequate, the requirement as to evidence of those expenditures should be responsive to the circumstances under which they were made. In our detailed statement we shall offer further comments on modification of the substantiation rules.

Finally, we wish to point out that the introduction of new conceptual tests which will permit subjective administrative interpretation and possible harassment of taxpayers, can only result in serious complications and further controversy in an already complex area.

SECTION 19

We recommend that section 19, providing for withholding of income taxes both on interest and dividends, be rejected. We recognize that there is underreporting in this area, and that this constitutes a serious danger to the structure of our self-assessment tax system. However, our conclusion is based on two considerations.

First, we believe that developments now underway can be counted on to narrow the underreporting gap to manageable proportions. This being so, the burden on the Government and the business community resulting from the proposal in section 19 of the bill would be unreasonable in the light of the benefits which might be achieved.

Second, we believe that from an economic viewpoint, the cost to be incurred by both business enterprises and the Internal Revenue Service will minimize, to a large extent, any increased revenues which would not already be forthcoming as a result of other measures.

As to the first item, over the past few years, the Internal Revenue Service has been actively engaged in a publicity campaign, through news releases, speeches by the Commissioner and others, and so forth, warning all taxpayers to examine their reporting practices to be sure that all taxable income, including specifically dividends and interest, is reported currently in tax returns. The business community, particularly large corporations which pay most of the dividends involved, has cooperated wholeheartedly in this activity, and it seems obvious that these steps have already had a material effect.

Furthermore, the Internal Revenue Service is actively engaged in installing its automatic data processing system, which will provide in the greatest detail information as to dividends and interest paid, with complete identification of the taxpayers. We are aware that even under these modern electronic systems, there will still be a burden on the Internal Revenue Service in associating the information supplied with the taxpayers involved, and that in practice a complete followup of this material will not be possible and, I may interject, I heard Mr. Dillon say this yesterday, and I think it is true.

But we think it crystal clear that the considerable publicity given to the capabilities of these reporting systems is by itself having a very significant effect on taxpayer compliance, and that by this activity alone the under reporting is being greatly reduced. The service is making strenuous efforts to inform the public, even outside the regions

scheduled for installation of these systems in the near future, of the capabilities of its automatic data processing system. It should be noted that the service is so confident that this publicity will result in much greater compliance, that it is informng the public that they must examine past practices and conform to the law; indeed, it is inviting taxpayers to take voluntary action now to correct returns already filed and has advised them how to do this. As a matter of fact, we believe that the campaign to warn people of the capabilities of the ADP system can be itself improve compliance to a greater degree than the service actually accepts as obtainable under the mechanics of the system.

With respect to the burdens on business, we believe that the business community is just beginning to realize the extent of the problem which they will face if section 19 is enacted. The proposal in the President's tax message of last year was for a simple withholding system at a single rate on all payments of dividends and interest involved. The business community was assured that it would not be faced with complications of identification and exceptions, even to the extent that it would not have to identify the taxpayer from whom tax was withheld.

Out of concern for the problems of the many taxpayers who actually owe no tax on their dividends and interest, or who because of circumstances would find that excessive tax was withheld, the House of Representatives enacted special exemptions and exceptions. This action has the effect of making the proposal, in general, highly objectionable from the standpoint of cost and difficulty. It should be understood that even a single exception creates by itself an enormous problem for business, particularly those dealing with large numbers of stockholders or creditors.

Automation is not confined to the Internal Revenue Service, and in fact many large organizations have necessarily installed electronic or similar equipment for disbursing dividends and interest. The requirement in the present proposal for distinguishing between taxpayers who wll be allowed to report to the payor that they do not expect to owe tax, or taxpayers from whom withholding must not be made merely because of their age, will in large measure destroy the efficient effectiveness of already installed and operating procedures for disbursing the payments. It is equally obvious that the policing of these exceptions by the Internal Revenue Service will be an enormous problem. The result will be a grafting of a procedure on our tax system, with heavy costs and administrative burdens, to solve a problem which is clearly becoming less material.

While we recognize that the exceptions are designed to provide equity, we think that if a withholding system is to be enacted, at the very least the burden of these exceptions should be solely on the Internal Revenue Service.

Finally, I wish to comment on the various sections of the bill affecting taxation of foreign income and activities of U.S. citizens and business enterprises abroad.

In our opinion these provisions are by far the most important proposals in the bill, with respect to their significance to the national welfare. The United States has spent many years and many billions of dollars restoring the economies of the countries of the Western World, with the intended result that we are now living in a world of

vigorous competition in international trade. We have encouraged countries abroad friendly to us to group together to improve their competitive position, and the Congress is even now considering authority to further promote freer exchange of goods and services across international borders. In accordance with clear national policy, we have encouraged our country's businessmen to take a leading part in developing the economics of the free world. The success of our private enterprise in world trade is completely apparent to everyone.

The foreign income and related sections of H.R. 10650 seem specifically designed to cripple our international trade at the very time when circumstances which our country had a large part in creating, make it increasingly difficult for our private business organizations to maintain and develop their positions abroad.

The effect of these proposals on the revenues may very well not produce the hundred million dollar revenue gain which the Joint Committee on Internal Revenue Taxation estimates.

These sections will force American business operating abroad to limit their activities, and in many cases reorganize them merely to maintain their position. In fact it has been our observation that even the threat of these changes in the Internal Revenue Code has already seriously hampered further expansion by U.S. enterprises in the foreign field. It seems to us abundantly clear that enactment of these provisions will result finally in significant net revenue losses and injury to our national economy, rather than the revenue gain predicted.

In fact, these proposals appear designed not to raise revenue, or to avoid improper manipulations (we believe present law with some relatively unimportant amendments is entirely adequate to prevent such abuses, and the Internal Revenue Service is right now engaged in a vigorous enforcement effort) but rather to direct by Government fiat the type of business and manner of operation of American free enterprise outside the United States.

In our detailed statement to be submitted, we shall expand our comments on the new and untried concepts proposed to be introduced into the Internal Revenue Code, the violence done to the spirit and intent of 21 bilateral tax conventions approved by the Senate, applicable to 44 countries of the free world, and the onerous—and it appears to us impossible—burdens of reporting and recordkeeping to be imposed on the business community. At this time I suggest only that the apparent intent and certainly the effect of these provisions will be to put U.S. businesses abroad in a most unfavorable position with competing business operating in the same areas.

The theory back of the proposals seems to be that an American-controlled enterprise operating in a foreign country should be treated on the basis of its competitive situation vis-a-vis a similar U.S. enterprise. This is not only totally unrealistic, but in fact the new proposals penalize the foreign enterprise. Most American businesses operating abroad, and certainly those which are producing the greatest revenue for our economy, are doing business abroad only because they are unable for many reasons to adequately supply foreign markets from this country. Such businesses are competing for the same markets sought by foreign enterprises operating in these areas. A local enterprise starts off with a competitive advantage against any

outsider, a fact of business life which is obvious to any European enterprise that tries to break into the American market. Thus at the very least an American enterprise which wishes to enter a foreign market should be allowed to compete on the same basis as its competitors already in that market, with the advantage of local ownership and management.

With the growth of country groupings in Europe and elsewhere (for example, the European Common Market), the concept of a local market is rapidly expanding across national borders. Some of the provisions in the bill impose tax penalties merely as the result of organizing to compete in the Common Market group or similar economic groups.

Not the least of the evils which would plague business if these sections are enacted is the authority given to the Treasury Department to make unilateral determinations affecting the tax burden of the domestic corporation. In many provisions authority is given to the administration, including the Treasury Department, to make unilateral determinations, from which no appeal appears possible. As one example, a formula is provided for allocating income under certain circumstances, with a further provision that intercompany prices may be determined on an arm's-length basis. However, determination of the arm's-length character of transactions is subject to rather rigid rules which may not give effect in every case to all of the pertinent factors. Moreover, if such arm's-length determinations by the taxpayer are not satisfactory to the Treasury Department, that Department through its agents can determine the allocations which in its sole judgment are proper, without any opportunity for an impartial appraisal. This, and similar approaches to these most difficult problems leave American business operating abroad entirely at the mercy of our bureaucracy. This uncertainty alone will surely cause American business to restrict operations abroad. It certainly creates no climate for new expansion.

I might also refer here briefly to another area calculated to produce uncertainty, difficulty, and unfair burdens on U.S. taxpayers. To a large extent, the provisions taxing U.S. shareholders on income of foreign corporations are couched in terms of "earnings and profits." This term is undefined in the Internal Revenue Code. Moreover, there is no hint or suggestion as to the rules to be followed. It is not even clear that the U.S. tax rules wil be applied in determining "earnings and profits." However, assuming U.S. rules will apply, American taxpayers, upon whom the burden has been thrust to make the determination, must attempt to restate "earnings and profits" with no guides as to the effect to be given to such items as depreciation, net operating losses, and many other points peculiar to U.S. taxation. This merely illustrates a few of the many complications which will arise from the introduction of wholly new concepts and terminology.

Much has been said about the favorable effect of these proposals on our balance of payments, and on utilization of American labor. Both of these assertions have been refuted by witnesses who appeared before the Ways and Means Committee representing the American business community, and our experience confirms these analyses. We believe that a major effect of the provisions would be to enrich the treasuries of foreign governments who would be quick to revise their

income tax structures to capture for themselves the revenues which these provisions are intended to bring to this country.

I have endeavored to point out that the complexities in this area, and in other parts of the bill, are by themselves serious. The very existence of uncertainties hampers business. Adding these complexities to the already complicated problems of doing business abroad will have the effect of discouraging many small businesses from expanding into the international trade area. The legislative history of the bill in the foreign income area emphasizes this important problem. Business enterprises have been forced to consider a regular series of proposals in the foreign area throughout the past year, and each one has required the immediate initiation of planning to avoid the severe and haphazard penalties which would be incurred under their present organization and manner of doing business. The latest proposals are only a few weeks old, and it cannot be expected that the picture is at all clear for the many organizations, large and small, which will be vitally affected. Yet the most basic provision, with respect to income of controlled foreign corporations, would become effective less than 9 months from now, and presumably just a few months after the final form of the provisions are known if they are approved by the Congress. The far-reaching provisions concerning liquidation and sale of stock would become effective upon enactment. At the very least, therefore, businesses should have more time to turn around and reorganize their activities to avoid possible destruction of their interests. It seems particularly inappropriate to legislate such far-reaching, new, and untried concepts in our tax structure at the very time when the Treasury Department is on record as preparing to release in the near future proposals for a basic reform of the tax structure.

We urge this committee to consider the serious impact of these proposals on the future expansion of American business in the field of international trade. We urge the committee to eliminate from this bill the proposals for taxing U.S. shareholders on unremitted and unrealized income from legitimate businesses—businesses which carry the American free-enterprise system to the far corners of the world.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Mills.

Any questions, Senator Gore?

Senator GORE. Yes, Mr. Chairman.

Mr. Mills, in your statement you are referring to the recommendation with respect to the taxation of foreign income contained in the bill before the committee and you say:

> In fact it has been our observation that even the threat of these changes in the Internal Revenue Code has already seriously hampered further expansion by U.S. enterprises in the foreign field.

Would you be specific and cite some examples?

Mr. MILLS. I can cite experiences our people have had, with clients, American corporations, who have been planning to expand operations abroad to make preparation for going into the Common Market, for example, and for the past year, they have not known what the final tax law would be.

American business groups, including those we represent, have been watching the development of the trade program, and have been

watching the development of the Common Market and the common markets in Latin America, and they naturally have been making plans to see whether they could get into those markets and increase their profits.

But, as I say here, the constant turmoil, if you do not mind my saying so, in this field as to what will be the final law, just makes it inadvisable in many cases to go ahead with these plans, so they have not done it.

Senator GORE. Well, now, you are speaking generally. You say you have clients. I will not ask you to divulge the names of your clients. But give me an example, example A of a U.S. corporation which has been in the situation where plans for expansion have been seriously hampered by the proposal in this bill.

Mr. MILLS. Example A is a corporation which has long been established, owned by a U.S. corporation in Great Britain. From Great Britain it has been supplying the market for its product on the Continent of Europe.

Now it has been clear for the last year or so that the company, to meet competition on the Continent, will be better off if it has an establishment in one of the continental countries, in one of the Inner Six countries, because while its position in Great Britain will presumably give it trade advantages in the Outer Seven, it will find tariff barriers greater than at present to get into the Inner Six.

If such a company, upon advice of its business people, thought that it would be well advised to keep the market already existing by establishing a manufacturing subsidiary in one of the Inner Six countries, it should go ahead and do so. But it has not known for the last year what the tax effect would be.

Senator GORE. Now, is this corporation, example A, engaged in manufacturing in Great Britain?

Mr. MILLS. Yes, sir; for the European market.

Senator GORE. For the European market. What is being hampered now are plans for the construction of an investment in an additional manufacturing facility in Western Europe, on the Continent.

Mr. MILLS. Either that or diverting some of its activities from Great Britain, or providing expansion which would normally be made in Great Britain for the market where these new trade barriers are not in prospect, to another country.

Senator GORE. How would that, as you say, cripple our international trade?

Mr. MILLS. Well, in my example, which is based on fact, although partially fabricated to make it easier to understand, this company is a substantial contributor to the U.S. earnings in that it is doing well, it has been in Europe a long time, is satisfying markets in Europe from its European manufacturing, which it could not satisfy from the United States. It will lose some of its market if it cannot get over this tariff barrier.

Senator GORE. It is not selling exports from the United States?

Mr. MILLS. Oh, yes. But it is primarily concerned with manufacturing in Europe products which it cannot bring from the United States in a competitive situation.

Senator GORE. Well, are you trying to say that a product of a factory in England or Germany, when sold in Western Europe, is tantamount to the sale of exports from the United States?

Mr. MILLS. Yes and no. The manufacture of industrial products in the case I have in mind, and I think it is typical of a great many, does two things: It creates, in a sense, a captive market for the U.S. parent for products which it can sell it to be refabricated, and it permits the U.S. parent, through its subsidiary, to get a market in Europe which it could not reach specifically from the United States because of prices and other things. If I may expand on it?

Senator GORE. Yes, sir; indeed.

Mr. MILLS. In industries such as machine tools or office equipment, industries of that character have been achieving rapid technological increase for some time, despite the advance of Western Europe, it is my understanding—and I have spent some time with people on this—that the European market is not as sophisticated as the United States; the European manufacturer is not as sophisticated as a U.S. manufacturer, so that there is competition in Europe from European manufacturers for the less sophisticated equipment. But there is still a need for the more sophisticated material from the United States.

Now, a U.S. manufacturer of that kind of equipment can get the best advantage for itself, its stockholders, and the U.S. economy by entering the market and manufacturing less sophisticated items there, using to the greatest extent possible U.S. components and, at the same time, keeping the U.S. market for direct export of the more sophisticated type.

If it does not get into the European market then it is in the position of only selling a few extremely expensive equipments against competition from abroad.

Senator GORE. Well, so many people tend to equate the manufacture and sale of a commodity abroad with U.S. trade. Indeed, it might be quite the reverse. The construction of additional manufacturing facilities in West Germany, for instance, upon which venture you say this company is hesitating now, might, if consummated, result in the export of large amounts of capital from the United States, thus worsening our balance of payments difficulties, and, in addition, increase the very competition in Western Europe of which you complain.

So I do not know how you equate the expansion of a manufacturing facility in England, even though owned by a U.S. interest, and additional production facilities, manufacturing facilities, in Western Europe with U.S. trade, and yet you cite this as an example.

This is being cited by you as an example of how this very proposal is hampering U.S. trade.

I think there is a vast difference. This proposed new plant might very well replace exports from the United States, as well as exports from England.

Mr. MILLS. Well, it is our observation, Senator, and it certainly was the observation of the industrialists who testified in the lower House, that the existence of the European manufacturing or trade subsidiaries was of tremendous value to U.S. direct exports because of the captive markets they had. But, of course, each corporation situation—I am talking about legitimate manufacturing corporations——

Senator GORE. Why do you say captive market? I do not understand that.

Mr. MILLS. Well, if corporation A in the United States owns corporation B in England, it certainly has a better chance to sell components to B than any other company has, and that is what I mean. It can direct its European operations to use to the greatest extent possible exports from the United States.

Senator GORE. You said earlier that if this additional manufacturing facility is constructed on the Continent of Europe it might, on the one hand, increase markets for the corporation or, on the other, it might supply markets which had previously been supplied by the factory in England.

If it will do that for the factory in England, isn't it likely to have a similar effect in a great many cases, if not an overwhelming proportion of the cases, on the products of the parent corporation in the United States?

Mr. MILLS. I would say not, Senator, in a great many cases. There may be isolated cases, but this is a complex problem, as you should know better than I.

Let me point this out: That these companies, American business, in our experience do not go abroad merely to go abroad. Despite what has been said, our experience is that they would much rather stay home and manufacture here and sell abroad; even the developed countries of Western Europe are less pleasant for Americans to live in than America.

Senator GORE. I understand. I do not indict the profit motive. I take it that our——

Mr. MILLS. The Secretary——

Senator GORE. Excuse me for just a moment. I agree with you they do not go abroad merely for the pleasure of exporting their capital. I take it they go to make an investment, as you and I would, in the hope of earning a reward.

This hope of profit is enhanced by the tax advantages, tax incentives, to go abroad. It is not to prevent investment abroad that I have been urging the Senate to take action. It is to remove the preferential treatment of income earned abroad.

Why we should penalize investment at home and reward investment abroad I do not comprehend.

Mr. MILLS. Sir, it is not just to get an advantage of larger profits because of lower taxes. It is because in so many cases the market is available only from Europe. I think despite the tariff results, economic conditions and transportation, among many other things, will just make it impossible to ship certain items from the United States to Europe and sell them at a profit without considering the tax features. They have to be processed there.

If I may comment on the tax advantage that concerns you, I think myself that we ought to look at the total tax burden on business in a country. I heard——

Senator GORE. Of a country?

Mr. MILLS. In each country, because I find myself feeling that it is not quite fair or it is not the complete picture if one compares the income tax rate with this country and another country and decides if the country's tax rate on larger corporations over a certain amount of income is 26 percent, that the tax burden is half of ours, because the country in Europe with a 26- or a 36-percent tax rate on income is

not necessarily, in fact, not usually, imposing a lesser burden on its business community and citizens, than we are, by getting it from other kinds of taxes.

Now, if a U.S. corporation, through its subsidiary, decides to operate in a country in Western Europe, it may find its tax rate on income is less than the U.S. tax rate on income of a similar sized corporation. But it is paying other taxes, such as payroll taxes, excise, and other taxes, and they can be very burdensome.

Now, if on the basis which you suggest, Senator, ways are sought to increase the portion of the tax which is measured by income to our income to U.S. rates, it seems to me it must follow that the total tax burden of operating abroad of an independent business corporation is greater than its competitors per se because there will be no provision for that company to get relief from the other nonincome tax. I hope I have made my point.

Senator GORE. Well, you make a point, the same point that was made this morning, that in order for U.S.-owned businesses abroad to compete on an equal basis each country must be compelled, should be compelled, to give to these foreign business operations preferential tax treatment. I simply do not agree.

Mr. MILLS. Well, I was trying to make the point, Senator, that it is not preferential tax treatment; it is equal tax treatment, and it would be——

Senator GORE. Equal with what?

Mr. MILLS. Equal with the people in their own market.

Senator GORE. Then if we compare it with income earned from a business operated in this country——

Mr. MILLS. No. But my point was that in many cases——

Senator GORE. Well, my point was a comparison between investment in the United States and investment in Western Europe.

Mr. MILLS. Yes, sir. But my point is that there is not a fair comparison here if a U.S. investor working in the United States could not enter the market at all, which is——

Senator GORE. If he enters the market—I seek not to prevent him from entering the market.

Mr. MILLS. I see.

Senator GORE. But if he enters the market and if he earns profits should he not pay taxes on those profits to the Government of the United States?

Mr. MILLS. Yes. When they are available for U.S. taxes.

Senator GORE. Well, I wish you would apply that yardstick to me.

Mr. MILLS. Senator, when the United States, when this Congress itself, met the problem some years ago on the use of the corporation form by people to avoid taxes, they set up a provision in the law which is still there to penalize persons who used the corporation to avoid taxes, and they did do two things, however, that differ from the concept of your proposal.

One is they imposed a penalty on the corporation that accumulated the funds, and this bill keeps saying that, "We are not imposing any taxes on foreign corporations."

The other thing was that they recognized that the intent to avoid U.S. taxes could not be present if the funds were not available for the tax.

It seems to me that the proposal in this bill, as amplified by the Secretary yesterday, ignored that economic fact that income may be earned economically under accounting systems, but it just is not there for taxes. Therefore, I do not see how you can take it.

Senator GORE. If it is earned income, or if it is realized profits, it is subject to tax liability. Now whether the taxpayer wishes to retain it and invest it in further growth, that is one thing.

Mr. MILLS. I agree with you. If it is earned income and realized profits, it is subject to tax, yes.

Senator GORE. Well, I started out to question your assertion that the uncertainty of this provision had already hampered foreign development. I wonder, in the case you have cited, example A, if the uncertainty of whether Great Britain is going to join the Common Market doesn't have a greater effect than the uncertainty of what Congress will do with respect to the administration's tax recommendation.

Mr. MILLS. It might be, but the decision is less momentous and less final because we are using this as an example, the company has no intention of leaving the British market.

What is feared is that it may find its present British operation, which is somewhat international, confined to the British market.

Senator GORE. Well, the example of uncertainty that you gave was that this company was contemplating a further expansion through the construction of additional manufacturing facilities not in England but in Western Europe.

Mr. MILLS. That is right.

Senator GORE. Which you said might reduce the operations in England.

Mr. MILLS. That is true.

Senator GORE. Now I ask you if the uncertainty of Great Britain's joining the Common Market isn't playing a greater part in this decision of the expansion from England to Western Europe, this leaping of the channel, than the uncertainty of what the U.S. Congress might do with respect to the administration's tax bill.

The provisions here would apply equally to an enlargement of the operations in Great Britain or an enlargement of the operations in Western Europe.

Mr. MILLS. I have no doubt it is part of their consideration. I am not able to equate whether it is greater or less. I know that the U.S. tax consideration is a major consideration for them.

Senator GORE. So this is not the only uncertainty involved?

Mr. MILLS. Oh, no. All these business matters are very complex. One of their problems that is being discussed now is where to locate in the Common Market. These are most complex problems.

Senator GORE. You are not then taking the position that the U.S. Congress should refrain from enacting a law which it thinks is fair and equitable because someone is uncertain as to what it might do.

Mr. MILLS. By no means.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Any further questions?

Senator CARLSON. Mr. Chairman, may I inquire of Mr. Mills? You discussed sections 2, 4, and 19, and the section affecting foreign taxation, that is affecting taxation of foreign income on the activities of our citizens abroad. Are there any sections of this bill that your organization or you personally favor?

Mr. MILLS. Yes, there are some. But I think overall it would be our belief that it would be better not to pass the bill at all.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Any further questions? Thank you very much, Mr. Mills.

(The supplemental statement follows:)

SUPPLEMENTAL STATEMENT OF COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SECTION 2—CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

1. *Section 2—General comments*

The investment tax credit as set forth in H.R. 10650 is a satisfactory version of an allowance to stimulate growth and investment in productive plant and equipment. It should be recognized that the tax credit is in no way a substitute for overall reform of depreciation policies and practices. Also, its enactment should not be taken by the Treasury as justification for delay in its announced program for depreciation reform and recognition of the inadequacy of present depreciation practices.

In the interest of assisting the Senate Finance Committee in considering specific provisions, should the committee decide to adopt a credit for investment in depreciable property, we present below several technical comments.

2. SECTION 2 (b)—PROPOSED SECTION 46 (C) (3)

Property used by public utilities

Property used in regulated public utilities should be entitled to the same credit as property used in other industries.

Utilities are competitive with other industries which will receive the full credit; it seems only fair that there be a uniform application of the credit. Furthermore, granting the same credit to utilities will tend to stimulate expenditures for construction in utility operations contributing to the goal of increasing capital investment.

It should be noted that granting an incentive to customers of utilities to build their own powerplants could result in creation of unnecessary duplicate facilities and inhibit the orderly growth of the controlled utility industry.

3. SECTION 2 (b)—PROPOSED SECTION 46 (d)

Limitations with respect to certain persons

The instructions with respect to which the credit is limited are generally those which have special bad debt allowances and those which are allowed to deduct distributions to participants. If the special bad debt allowances are proper, either as representative of needed reserves or as a method of reducing the impact of taxation, there is no reason to reduce the credit otherwise available. In the case of institutions allowed to deduct distributions, the apparent purpose is to avoid the double taxations that would prevail in the absence of the deduction. This amelioration of double taxations should not stand in the way of allowing the proposed credit against any portion of single tax that the institution is required to pay.

4. SECTION 2 (b)—PROPOSED SECTION 48 (a) (1) (B)

Service industries and storage facilities

Provisions should be made to include in the definition of "section 38 property" tangible property of service industries and storage facilities used for finished goods.

Section 48(a) (1) (B) should be amended to cover service industries and storage facilities used for finished goods. While the House committee report (p. 11) notes that such facilities as grocery counters qualify, it does not appear that they fall within the statutory definition of "section 38 property."

5. SECTION 2(b)—PROPOSED SECTION 48(a)(3)

Property used for lodging

Property used in the business of furnishing lodging should be entitled to the same treatment as other property.

Property used predominantly to furnish lodging or in connection with the furnishing of lodging is specifically excluded from the definition of section 38 property. It would appear that the exclusion would extend to property used for housing workers at a new manufacturing plant where adequate facilities are not available. It seems it would be necessary in this situation for taxpayers to prove that the property in connection with lodging is an integral part of manufacturing, production, etc., under proposed section 48(a)(1)(B)(i).

6. SECTION 2(b)—PROPOSED SECTION 48(c)(2)(D)

Allocation of partnership credit

Provision should be made for allocating the credit on qualified investments of a partnership.

The proposal should be clarified with respect to the method of allocating the total tax credit generated by partnership investments to the partners. We recommend legislative provision for such allocation.

7. SECTION 2(b)—PROPOSED SECTION 48(d)

Certain leased property

The right of the lessor to a separate election with respect to each item of leased property should be made clear.

It is not made clear whether or not the lessor may elect separately as to each item of leased property. Unless the provision is clarified, the Secretary may rule that each lessor must make a single election with respect to all leased property. Such a ruling would seriously restrict the leasing business.

Provision should be made for taxpayer who leases property from the Government to obtain the credit. It frequently is in the best interests of the Government procurement agencies to hold title to productive property from the beginning, although for all practical purposes the taxpayer contractor initiates the purchase and has full control over the property.

8. SECTION 2(c)—PROPOSED SECTION 381(c)(23)

Certain corporate acquisitions

The right of an acquiring corporation to any unused credit of the transferor should be made clear.

In its present form, the proposal states that the acquiring corporation shall take into account the items required to be taken into account for purposes of proposed section 38 in respect of the distributor or transferor corporation. This rule is stated to apply to the extent proper to carry out the purpose of the applicable sections and under regulations to be prescribed. It should be made clear that any unused credit of the transferor is to be available to the acquiring corporation in all events.

SECTION 3—APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

1. SECTION 3—PROPOSED SECTION 162(e)

Payments to influence legislation

Expenses incurred to defeat or promote legislation should be deductible if the purposes therefor and the methods used do not violate Federal or State laws and the expenses are otherwise deductible. This should include payments to influence public opinion.

We call your attention to recommendation No. 6, page 5, of our booklet of Recommendations for Amendments to the Internal Revenue Code which was submitted to the Congress on February 28, 1961. With respect to code sections 162 and 212, it was recommended that:

"Expenses incurred to defeat or promote legislation should be deductible if the purpose therefor and the methods used do not violate Federal or State laws and the expenses are otherwise deductible.

"The regulations bar the deduction of expenditures incurred for the promotion or defeat of legislation without making any distinction between proper and improper expenditures and regardless of whether the expenditures are otherwise ordinary and necessary under the circumstances. The law itself does not seem to prohibit the deduction of such expenditures, but regulations prohibiting it have been in effect so long that the courts hold that they have the effect of law.

"In recent cases, the U.S. Supreme Court has upheld the disallowance of expenses incurred to defeat legislation which, if adopted, would have completely eliminated the taxpayer's trade or business. The expenses were not illegal or immoral and were clearly necessary to preserve the very existence of the taxpayer's trade or business.

"The Congress and other legislative bodies frequently invite testimony of professional and business leaders when they are considering legislation. We believe the taxpayers not only have the right but have an obligation to express their informed opinions and share their experiences with legislators and the public generally. When such activities bear a close relationship to the taxpayer's trade or business or to other activities engaged in for the production of income and the methods employed are legal and moral, the expenses thereof should be deductible for income tax purposes."

Proposed section 162(e) seems unduly restrictive since it prohibits expenditures for the promotion or defeat of legislation which attempts to encourage the public to take a position with regard to a matter. While informing legislative bodies is important and in the public interest, it is equally desirable that administrative agencies and the public be informed as to legislative or constitutional matters. It should be made clear that expenses related thereto are deductible if ordinary and necessary under the circumstances.

Whether our recommendation is or is not adopted we believe that the wording of the bill should be changed to eliminate the requirement that the expenditure be of "direct" interest to the taxpayer. The requirement of a "direct" connection with the taxpayer's business may give rise to unnecessary disputes with the Internal Revenue Service. It should be sufficient if the expenditure meets the normal "ordinary and necessary" test applicable to other business expenses.

SECTION 4—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

1. SECTION 4—PROPOSED SECTION 274

Less severe legislation is required

> We agree that widespread abuses of entertainment expense deductions should not be tolerated and that any legislation should be sufficient to provide adequate statutory strength for effective administration. However, past abuses, which resulted in a large measure from inadequate administrative activity, should not be used as justification for changes that deal unfairly with business taxpayers, discriminate among taxpayer groups, and introduce difficult and untried conceptual tests which lend themselves to subjective administration and which may be used for harassment of taxpayers by revenue agents.

Widespread abuses should not be tolerated.—A distinction should be made between dramatic examples of relatively extreme abuses that represent exceptions to the general pattern and widespread abuses that constitute a general pattern in themselves. It is our observation from dealing with the affairs of many different taxpayers that abuses of entertainment and travel expense deductions have not been as great or as widespread as might be inferred from the material presented to the House Ways and Means Committee by the Secretary of the Treasury. The pattern is one of substantial compliance. Unfortunately, extreme exceptions have been used to suggest a pattern of noncompliance. Changes in the law should be confined to those necessary to prevent widespread abuses; occasional extreme abuses can be dealt with administratively.

Entertainment and travel expenses are not improper or immoral.—Some of the arguments made in favor of the new proposals are extreme; for example, it has been stated that the proposals will strengthen the tax structure and also the moral fiber of our society. We do not agree with any implication that the present rules regarding entertainment and travel expenses are improper or immoral. Proper entertainment expenses made to maintain good relations with present customers and to foster amicable relations with prospective customers should be deductible. Frequently, travel and entertainment expenses

are another form of advertising and when based on good business judgment, represent a reasonable attempt to increase revenue which in turn should increase taxable income.

The obvious desire of entertaining those whose favor is sought can be seen in the numerous official functions which our Government and other governments conduct in order to maintain and to improve international relations. Surely no reasonable person would suggest that such expenditures are not in the national interest. In similar fashion, expenditures made to foster legitimate business interests should not be disallowed arbitrarily. On the other hand expenditures which lack a reasonable relationship to the conduct of the business should not be deductible.

Legislative changes should be made to the extent necessary to permit effective administration.—A large part of the present problem stems from inadequate and ineffective past administration of the law with respect to entertainment and travel expense deductions. While the law should be adequate from an administrative viewpoint, it should not be so stringently drawn as to overcompensate for past administrative failures. The inadequacies of past efforts are illustrated by the stepped-up activity of the Internal Revenue Service in recent months in obtaining more detailed information from taxpayers, in improving audit activities in connection with entertainment and travel expense deductions, and in developing more cases against deficient, negligent, and fraudulent taxpayers. This suggests that much of the problem might have been solved in the past by administrative action and that continued emphasis on similar administrative efforts may provide partial answers in the future without infringing unduly on the freedom of taxpayers to make sound business decisions.

Corrective legislation should not be the occasion for creating structural flaws that deal unfairly with business taxpayers or discriminate against taxpayer groups.—The bill in its present form contains substantial elements of discrimination, especially against small taxpayers. The proposed prohibition against entertainment activity not "directly related to the active conduct of the taxpayer's trade or business" will prevent much of the activity that the small taxpayer uses legitimately in business furtherance and development. This prohibition is less significant to the large, well-established taxpayer. In addition, the exceptions to the prohibition tend to operate in favor of the larger business. Exceptions described in proposed section 274(d) (2), (5), and (6) relieve the large business of possible nondeductibility of expenditures that the average small business is not able to afford. To the extent that taxpayers would be forced to pay entertainment expenses out of capital funds, instead of as deductions from income, the small and inadequately capitalized company would be seriously handicapped.

In any event, difficulties of administration should not be used as the reason for enacting what for many taxpayers would be punitive legislation.

Serious complications will result from the introduction of new conceptual tests that will permit subjective administrative interpretation and possible harassment of taxpayers by Internal Revenue agents.—Taxpayers already are faced with the extreme proliferation of a tax law that is topheavy with technical complexities and, at the same time filled with conceptual obscurities that lend themselves to subjective interpretation. Section 4 of the bill is particularly faulty because it would add a number of concepts that would present new battlegrounds for haggling between taxpayers and the Internal Revenue Service and would require substantial litigation before they could be interpreted adequately. As presented in the bill and explained in the report of the Ways and Means Committee, they would permit subjective interpretations that could only result in harassment of taxpayers. It is our view that in this whole problem of entertainment and travel expense deductions, too little has been said of the many occasions on which taxpayers have been unable to obtain deductions (to which they were entitled) because of their unwillingness or inability to engage in lengthy contests to maintain their rights.

These problems will be accentuated by new requirements for determining whether expenditures are "generally considered to constitute entertainment, amusement, or recreation;" whether they are "directly related to the active conduct" of the business; whether they are more or less than one-half for the furtherance of the business; whether the specific evidence as to their having been made is adequately more "sufficient" than in the past; and whether the travel portions are sufficiently "reasonable" in addition to being ordinary and necessary. We believe adequate corrective legislation could be written without the necessity of relying to this extent on obscure concepts that can only cause difficulties in the future.

2. SECTION 4—PROPOSED SECTION 274

Legislation suggested

Improvements in the structure of the law can be made that will substantially correct its weaknesses for administrative purposes without unduly inhibiting legitimate business activities. Such improvements would include the proposed prohibition against business gifts and, with some modification, the proposed abandonment of the Cohan rule. They would also include a requirement of a primary relationship between entertainment expenditures and business furtherance.

Business gifts—proposed section 274(b).—We believe that a dollar limit on business gifts intended to satisfy the personal, living, or family needs of an individual is entirely appropriate. Recognition should be given, however, to the fact that some so-called business gifts carry actual or implied advertising message and are intended for use on business premises or in connection with business activities. Where they are thus business related they represent instruments of sales promotion of lasting value and cannot be duplicated by other forms of advertising. To the extent that they meet these qualifications there should be no arbitrary dollar limit.

Substantiation requirements—proposed section 274(c).—Although the Cohan rule has long been established as a theoretically reasonable approach to expense substantiation, it has been increasingly clear that the presence of the rule represents a difficult administrative obstacle to the Internal Revenue Service. Therefore, the force of the rule should be eliminated.

At the same time it should be recognized that the rule stemmed originally from the difficulties of substantiation in an area where recordkeeping tends to be burdensome and inexact. The elimination of the rule should not be in terms that create a burden greater than that in existence before the rule was established. Where a taxpayer's record of expenditures might not be adequate, the requirement as to evidence of those expenditures should be responsive to the circumstances under which they were made. The language of the Ways and Means Committee report suggests that corroborating evidence in connection with the amount, time, place, date and description of an expenditure must be specific and direct in order to be considered sufficient. This is a very burdensome and unrealistic requirement and may encourage taxpayers to fabricate supporting records. If evidence is offered with respect to each occasion for expenditure, circumstantial evidence should be sufficient as to details of the expenditure provided that there is direct evidence as to the time, place, and date of the general occasion.

It should be recognized also that incidental expenditures are almost impossible to support. Although the possibility of a de minimis rule is recognized in the Ways and Means Committee report, the establishment of such a rule for incidental expenditures should be directed in the statute.

Disallowance of expenditures for entertainment expenses should be limited to those that are not primarily related to the furtherance of the taxpayer's business.—The prohibition against entertainment expenses not directly related to the production of income (as that prohibition is explained in the Ways and Means report) presents too sharp a departure from established business practices. The problems that have arisen in this connection in recent years have for the most part been in situations where there was only a tenuous relationship between the expenditure and the general business objectives of the taxpayer. This situation should not be permitted. On the other hand it is going too far in the opposite direction to use language that would prohibit deductibility for all practical purposes except where an income-producing business relationship already has been established or is likely to be established following the occasion for the expenditure.

To deny a deduction for goodwill expenditures infringes on the business judgment of the taxpayer. To say that he may make those expenditures but not deduct them means that to that extent he must pay tax on his gross income instead of on his net. Expenditures for goodwill which may at times seem large in amount frequently result in revenue and taxable income which also is large.

There should be adequate opportunity for administrative control if, in addition to the elimination of the Cohan rule, the law were changed to require that in order to be deductible expenditures for entertainment should be primarily related to the furtherance of the trade or business. Adoption of this approach would also permit the elimination of most of the exceptions of proposed section 274(d).

3. SECTION 4(a)—PROPOSED SECTION 274(a)(1)(A)

Activity

Subjective tests as to activities "generally considered" to constitute entertainment, etc., and "directly related" to the active conduct of the business introduce uncertainties that will result in extensive litigation.

The subjective tests as to activities "generally considered" to constitute entertainment, etc., and "directly related" to the active conduct of the business introduce uncertainties that will result in extensive litigation. If they are to be retained, they should be described in terms that will be meaningful. In fact, the difficulty of arriving at such a description is one reason for not adopting these tests in the first place. It is not sufficient to say that there must be a "greater degree of proximate relation" than required under present law or that there will have to be "more than a general expectation of deriving some income at an indefinite future time." The arguments that will be created by statements such as these will be endless.

If the "directly related" test is retained, the apportionment of expenditures between those directly related and those not directly related to the active conduct of a business would prevent deduction for expenditures that are for business furtherance and not in any sense personal. Thus expenditures for guests invited to a function intended primarily for furtherance of the business would not be deductible unless one of the specific exceptions of section 274(d) is met. This approach seems unwarranted.

4. SECTION 4(a)—PROPOSED SECTION 274(a)(1)(B)

Facility

The requirement that a facility be primarily for furtherance of a business could place administrative expediency ahead of equity.

While it is reasonable to require that an expenditure be primarily for the furtherance of a business, it is not fair or reasonable to ignore the fact that the acquisition of a given facility may require an outlay that may be useful for both business and personal purposes without departing from standards of propriety. Failure to accord such recognition merely results in placing administrative expediency ahead of equity. While there may be some de minimis use below which business use of a facility should not be recognized, that point certainly is not at the 50 percent level.

5. SECTION 4(a)—PROPOSED SECTION 274(d) (4), (6) AND (7)

Specific exceptions

Less demanding substantiation rules should be provided for reimbursed expenses in connection with services performed for someone other than an employer. The exceptions for reimbursed expenses and for attendance at business meetings should be equally applicable to partners. Clarification is needed whether attendance of a business-related meeting not conducted by an exempt organization falls within the exception for expenses of attending meetings of business leagues.

Proposed section 274(d)(4)(B)—Exception for reimbursed expenses

The exception for reimbursed entertainment expenses in connection with services performed for someone other than an employer applies only where the taxpayer reports to the other party with the same degree of substantiation as would be called for by proposed section 274(c). This degree of substantiation departs completely from reasonable business practices. The reporting burden to taxpayers in the business of rendering services to clients and customers would be prohibitive and should be unnecessary in view of the natural policing that occurs in business arrangements conducted at arm's length. Less demanding substantiation rules should be provided for this purpose.

Proposed sections 274(d)(4) and (6)—Exceptions for partners

The exceptions for reimbursed expenses and for attendance at business meetings should be equally applicable to partners. This will be a particular problem of large partnerships with extensive operations throughout the country.

Proposed section 274(d)(7)—Exception for expenses of attending meetings of business leagues

This exception is entirely appropriate except that by not going far enough it may be interpreted to mean that a business-related meeting not conducted by an exempt organization will not be subject of an exception. The question may be raised as to whether the deductibility of expenses of attending technical business conferences without such sponsorship will depend on whether the conferences were directly related to the conduct of a trade or business in that they were productive of business income.

6. SECTION 4(b)—PROPOSED AMENDMENT TO SECTION 162(a)(2)

Traveling expenses

Applying a new test of reasonableness for meal and lodging expenditures in travel status merely provides a new area of interpretation and litigation. A better corrective measure would be to reintroduce the ordinary and necessary test to expenditures of this type.

The principal difficulty with present section 162(a)(2) is that the entire amount of meal and lodging expenditures is viewed as deductible without regard to the relative necessity of the amount expended. All that is necessary to correct this situation is to reintroduce the ordinary and necessary test to expenditures of this type. Applying a new test of reasonableness would merely provide a new area of interpretation and litigation that should not be necessary. The desired effect could be accomplished without hardship to taxpayers by changing the present parenthetical clause of section 162(a)(2) to read "(including expenditures for meals and lodging)."

7. SECTION 4(C)

Effective date

The effective date should be advanced to December 31, 1962. In view of the many new and subjective tests that will require considerable clarification by regulation and considerable adjustment by taxpayers to the recordkeeping requirements, the effective date should be advanced to December 31, 1962. The effective date should not be keyed to the date of promulgation of regulations since it would be unwise to force undue haste in the resolution of these difficult interpretative problems.

SECTION 5—AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

1. SECTION 5—GENERAL COMMENT

Foreign corporate shareholder not engaged in trade or business in the United States

The proposal should apply to distributions of property in kind to a foreign corporate shareholder not engaged in trade or business in the United States.

In the case of distributions in kind by foreign corporations to corporate distributees, this section treats as dividend distributions the fair market value of the property distributed. This provision embodies, in part, recommendation No. 15, page 15, of the "Recommendations for Amendments to the Internal Revenue Code" submitted to the Congress on February 28, 1961. The amendment should also include similar provisions regarding distributions of property in kind to a foreign corporate shareholder not engaged in trade or business in the United States. This additional change was included in the recommendation since the distributions to foreign corporate shareholders are not generally subject to the dividends received deduction.

2. SECTION 5—GENERAL COMMENT

Reduction of earnings and profits

Provision should be made for reduction of the earnings and profits of the foreign corporations by the amount required to be included in the gross income of the distributee under proposed section 1248.

No provision is made for reduction of earnings and profits of the foreign corporation by the amount required to be included in the gross income of the distributee as is provided in proposed section 1248 with respect to amounts previously included in the shareholder's income under proposed section 951. Proposed section 1248(b)(3) makes such a provision, but only for the purpose of proposed section

1248(a). The proposal should take into account amounts includible in gross income of distributees by reason of the application of proposed section 951. Otherwise, earnings and profits will in some cases be taxed twice to the U.S. shareholders.

3. SECTION 5(d)—PROPOSED AMENDMENT TO SECTION 902(a)

Credit for foreign taxes

It is inequitable to limit the amount of the distribution in kind to the lesser of the adjusted basis of the property (in the hands of the distributing corporation) or its fair market value.

Proposed section 5(d) provides that for the purposes of computing the foreign tax credit, the amount of the distribution in kind is limited to the lesser of the adjusted basis of the property (in the hands of the distributing corporation) or its fair market value. This is an inequitable limitation on the amount of the foreign tax credit available. The credit should be determined by reference to the fair market value of the property, rather than the lower of the adjusted basis or fair market value, to the extent that fair market value is the measure of U.S. tax.

4. SECTION 5(e)

Effective date

The effective date should conform to other sections of the bill.

The effective date provisions of section 5 should be equated with those of other sections of the bill so that amounts taken into income under the provisions of the bill in excess of amounts which would be taxed under existing law are limited to earnings accumulated after December 31, 1962.

SECTION 6—ALLOCATION OF INCOME BETWEEN RELATED FOREIGN AND DOMESTIC ORGANIZATIONS

1. SECTION 6—AMENDMENT OF SECTION 482

Amendments should not be adopted

This proposal attempts to inject a mechanical computation as a means of allocating income in order to make what is essentially a subjective determination. The amendment to section 482 is unnecessary because that section as presently written is broad enough to accomplish the results which the proposed amendment is designed to achieve. According to the explanations in the House committee report, this provision seems to be aimed primarily at U.S. corporations with foreign subsidiaries. However, it would apply equally to domestic subsidiaries of foreign corporations and would present almost insuperable problems in its attempt to allocate income on a mechanical basis.

Present law allows the Secretary or his delegate to distribute, apportion, or allocate gross income, deductions, credits, or allowances between taxpayers where he determines that such an approach is necessary in order to prevent the evasion of taxes or to more properly reflect the income of the various businesses. The present law, by its generality, allows a determination to be made under the facts and circumstances most appropriate to the situation involved.

Any method which attempts to substitute a mechanical approach to the determination of the propriety of the reporting of income between related groups must of necessity create undue hardship in some instances and unintended benefits in others because all businesses are not conducted on the same basis, and accordingly, any set of standards developed for one business will obviously be inappropriate for a different business.

The proposed addition to section 482 would require allocation of income based primarily upon a three-factor formula. The provision does state that the method of allocation may also give consideration to other factors including the special risk of the market, but such consideration is completely discretionary. It is possible that special risk and other factors giving rise to higher sales prices in the foreign country will not be recognized by the Commissioner. It would appear that the taxpayer would have no redress if the Commissioner refused to recognize special risk and other factors. Again, it is also possible that the income with respect to a particular product will not be determinable by an allocable ratio of the three factors considered. While the domestic corporation may have rather substantial investments and incur substantial costs within the three areas, the foreign operation may not be different than the product mix of the domestic corporation.

The so-called safeguards provided are largely unrealistic and can be expected to be ineffective. Basically, they provide that if an alternative method can be produced by the taxpayer which will satisfy the Secretary or his delegate that it will clearly reflect income, then it shall be used; or, on the other hand, if it can be demonstrated that arm's-length price was arrived at then no adjustment will be made. The arm's-length possibility is not expected to afford much relief because it is unlikely that there might be similar or comparable products sold to unrelated persons as required. A further limiting factor on the so-called protective clauses is the provision that no amount will be allocated to foreign organizations whose assets, etc., located outside the United States are grossly inadequate for its activities outside the United States. It appears that should such a situation exist no amount of income would be allocated to a foreign organization even though a suitable alternative method might be found or an arm's-length price established.

This "grossly inadequate assets test" could encourage a manufacturer to increase operations in foreign countries and discourage the manufacture of products in the United States. This may provide the incentive that some domestic manufacturers need to remove themselves from the current domestic wage problem thereby increasing the problems confronting the economy.

It appears that any method used in determining sales prices to foreign subsidiaries could be attacked. It is not unreasonable to assume that in almost all cases the Commissioner will take the approach of applying the mechanical tests outlined in this proposed amendment. The realities of prices and costs in the foreign market must be substantiated by the taxpayer and circumstances may not allow him to carry his burden of proof.

The enactment of this provision would be a deterrent to the investment in the United States by foreign corporations because of the obstacles which would be presented by attempts to reallocate income to U.S. subsidiaries of foreign companies. Foreign corporations would be reluctant, and in many cases, would find it impossible to make available information necessary for a reallocation of income under the terms of the proposed amendment.

The amendment provides that foreign taxes applicable to income reallocated to a domestic corporation shall be considered as having been paid by the domestic corporation. The House committee report indicates that income so reallocated is not to be considered as foreign income for purposes of determining the foreign tax credit limitation. This is inequitable since in most situations the domestic company would derive no benefit from the foreign tax credit unless such income is considered to be income from foreign sources which it actually would be under the circumstances. If the credit is not allowed to the domestic company the excess taxes paid would, in effect, be taxed in the United States and could never be realized because it has been paid to a foreign country.

Finally, the effect of the proposal may produce an unintended result. For example, in a group of organizations consisting of one foreign organization and two domestic organizations, the proposal may be construed to apply to transactions which involve only the two domestic organizations. Certainly this interpretation of the proposal is not intended and the statute should be clarified to prevent it.

SECTION 7—DISTRIBUTION OF FOREIGN PERSONAL HOLDING COMPANY INCOME

1. SECTION 7—PROPOSED AMENDMENTS TO SECTIONS 552 AND 556

Definition of foreign personal holding company

The proposed 20 percent "gross income test" for purposes of defining a foreign personal holding company is too low; it may create unintended hardships. Present law should be retained.

Present law taxes the income of foreign personal holding companies to certain U.S. shareholders only if 60 percent (or in certain circumstances 50 percent) of the income of such corporation is from foreign personal holding company income sources. Under the bill, the foreign personal holding company income will be taxed proportionately to the shareholders if it represents 20 percent or more of its income. The 20-percent determination is too low and present law should be retained.

Situations may develop where temporarily unprofitable operations will cause otherwise nominal income from personal holding company sources to exceed the 20-percent limitation. In this situation, the domestic shareholders could be placed in an awkward position where income cannot be distributed because of

working capital restrictions or for other reasons dictated by foreign law requirements. These shareholders will pay a tax on income which they cannot enjoy currently, or which they may never enjoy.

Section 9—Distributions by Foreign Trusts

1. SECTION 9—GENERAL COMMENT

We favor the principle of equating the tax position of beneficiaries of foreign trusts with that of beneficiaries of domestic trusts.

It is difficult to envisage a purpose for the creation of a foreign trust for the benefit of a U.S. person other than the avoidance of tax which would have been payable by the beneficiary had the trust been created in the United States.

2. SECTION 9(c)—PROPOSED AMENDMENT TO SECTION 666(a)

Period of the throwback

If the period of throwback for a foreign trust is to exceed 5 years, then the period of throwback should be similarly extended for domestic trusts. Conversly, if the 5-year period is appropriate for domestic trusts, the same period should be applicable to foreign trusts.

In the interests of uniform treatment and minimization of complexities of administration, we believe the same period should apply to both foreign and domestic trusts.

3. SECTION 9(e)—PROPOSED SECTION 669(a)

Elective tax computation

We see no reason for interjecting a second alternative method of computing the tax attributable to receipt of an accumulation distribution from a foreign trust.

This additional alternative made available only to beneficiaries of foreign trusts is presumably a relief measure designed to even out the impact of varying accumulations from year to year and to eliminate the necessity of accumulating data with respect to early years. If the period of throwback is made the same for foreign and domestic trusts, and even if not, we see no justification for mitigating the burden for the beneficiaries of foreign trusts. A uniform rule applicable to all taxpayers is certainly to be preferred over further exceptions.

4. SECTION 9(g)—PROPOSED SECTION 6677

Civil penalty for failure to file return

A civil penalty would be imposed for failure to file a return under proposed section 6047 regardless of whether failure to file was due to "willful neglect." Section 7203 of present law imposes sufficient penalty for willful failure to file a return.

An additional penalty should not be imposed because of other penalties already in the code.

5. SECTION 9(j)

Effective date

The postponement of the effective date of the application of the amendments to accumulation distributions made in the first taxable year after enactment appears to offer an opportunity for avoidance in the case of some foreign trusts if the proposals are enacted.

The proposed amendment to section 665(b) would not allow exceptions to accumulation distribution treatment in the case of foreign trusts which are now available to domestic trusts. This treatment of distributions of foreign trusts will not become effective until the year of the foreign trust beginning after the date of enactment. Thus, in the case of a calendar year foreign trust, it would have until the end of the year to make distributions which would not be affected by the proposed changes. If the distribution could be excluded under section 665(b), the beneficiaries would be taxed only on the distributable income of the current year. Some trusts could qualify, others not, and the difference could be the purely fortuitous circumstance of attainment of age 21 or birth of a beneficiary or the fact that the trust had been in existence more than 9 years. We believe that the proposals, if enacted, should all be applicable to distributions made after the date of enactment.

SECTION 11—DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

1. SECTION 11—PROPOSED AMENDMENT TO SECTION 902 AND PROPOSED SECTION 78

Grossing-up foreign dividends

The proposal known as grossing-up foreign dividends is unwarranted and unfair. In certain instances the proposal would require the payment of U.S. tax on a portion of the subsidiary's earnings never received by the domestic parent company. It will provide little additional revenue to the United States and will discourage investments in less developed countries (contradicting the stated aims of the administration).

Present law requires domestic parent corporations to include dividends actually received from a foreign subsidiary. As proposed, the recipient corporation must include in taxable income the amount of dividends actually paid plus the amount of income tax paid by the foreign corporation on earning the distributed amount. Thus, the proposal would impose U.S. tax on a portion of the foreign subsidiaries' earnings never received by the domestic parent corporation. This can be illustrated by the following:

Assume a foreign subsidiary has earnings of $100,000, pays $20,000 in foreign taxes, and $80,000 in dividends.

	Present law	Proposed law
Dividend	$80,000	$100,000
U.S. tax before credit—52 percent	41,600	52,000
Less foreign tax credit—20 percent of dividend	16,000	20,000
U.S. tax after credit	25,600	32,000

In relation to the subsidiary's earnings of $100,000, the aggregate tax is $45,600 or 45.6 percent under present law ($20,000 foreign tax plus $25,600 U.S. tax) and 52 percent under proposed law ($20,000 foreign tax plus $32,000 U.S. tax). However, the aggregate tax rate under present law based on the amount of the dividend actually received also is 52 percent or $41,600 ($25,600 U.S. tax plus $16,000 foreign tax; i.e., $80,000 divided by $100,000 times $20,000 equals $16,000), equaling the U.S. rate (52 percent of $80,000 equals $41,600). It should be noted that the computation of the U.S. tax under the proposal ignores the $20,000 foreign tax actually paid and requires the computation to be made on the basis of the full $100,000 earnings of the subsidiary rather than on the dividend of $80,000 actually received by the domestic parent.

It seems to us that the existing method of computing the foreign tax credit is reasonable and should not be changed. The credit provision was first introduced into the law in 1918. Its purpose was to subject the actual dividends received on foreign investment to no more than the effective U.S. rate of tax.

One of the arguments raised in support of the grossing-up provision is that it would achieve equality of taxation between the foreign subsidiary and the unincorporated foreign branch.

We believe the urge to achieve such equalization is not realistic since the circumstances are different. For example, foreign subsidiaries are not entitled to certain benefits allowed to foreign branches of domestic corporations; foreign losses suffered by a branch are deductible from the domestic corporation's profits.

It should be noted that the effect of the proposal is to increase the U.S. tax on dividends from corporations located in foreign countries where such countries impose a tax rate of less than 52 percent. It could be expected that any additional revenues to be obtained from grossing-up must come out of dividends from foreign subsidiaries in countries with low tax rates. Generally, this would mean the less developed countries. The result may be that the grossing-up proposal will discourage the locating of foreign investment in these countries thereby contradicting the stated aims of the administration to encourage investments in less developed countries.

Finally, the proposal could adversely affect U.S. revenues where the foreign tax rate exceeds the U.S. tax rate. In this situation, grossing-up would produce a greater excess credit with respect to the dividend, which could be applied

against tax on other income from the same country or against tax on income from another foreign source under the overall limitation.

2. SECTION 11(b)—PROPOSED SECTION 78

Dividends received

The proposal will have substantial effect on the tax status of U.S. corporations apart from the effect on the foreign tax credit itself.

The provision of proposed section 78 treating taxes deemed paid as dividends received for all purposes of the internal revenue title (other than section 245) can have substantial effects on the tax status of U.S. corporations quite apart from the effect on the foreign tax credit itself.

For example, the increase in dividend income and gross income which would be caused by the proposal can result in a corporation becoming a personal holding company or a foreign personal holding company. Other results might be loss of Western Hemisphere Trade Corporation status and increases in the amount of allowable charitable contributions. Recognition should be given to these effects by providing for exceptions to the treatment as dividend income.

SECTION 12—EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

1. SECTION 12(a)—PROPOSED AMENDMENT TO SECTION 911(C)(4)

Amount excluded from gross income

It is inequitable to have mere passage of time as the controlling factor in the determination of the amount excluded from gross income.

Section 911(c)(4) proposes to deny exemption to any amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed, even though the amount would otherwise qualify as exempt foreign earnings.

It appears inequitable to have the mere passage of time as the determining factor. Financial condition of the employer may cause delay in receiving payment, and an unscrupulous employer may use this time limitation as leverage to settle a dispute with a former employee to whom wages are still owed.

An individual's taxable year terminates upon his demise, hence the requirement that the amounts, to be exempt, must be received within "the taxable year following the taxable year in which the services * * * are performed" could deny exemption to an amount received by a decedent's estate (or heirs) only shortly after the decedent performed the services. For example:

A decedent, who reports his income on the calendar year, terminates his foreign employment on December 31, 1963. On January 2, 1964, he dies, and 2 weeks later a participating bonus relating to the last year of decedent's employment is received from the employer.

Since death terminated the employee's taxable year on January 2, 1962, subsequent receipt of the bonus will be denied exemption because of having been received "after the close of the taxable year following the taxable year in which the services * * * are performed." The credit for estate tax paid on the value of the bonus will frequently give only partial relief.

2. SECTION 12(a)—PROPOSED AMENDMENT TO SECTION 911(C)(5)

Amounts not excludable

It seems illogical to deny exemption of any amount received as a pension or annuity, although the amount is attributable to earnings which meet the exemption limitations of section 911(a).

Since a pension or annuity is paid from a fund of savings which, in a manner of speaking, was accumulated out of the employee's exempt foreign earnings, it seems illogical to allow the employee exemption of the portion of the foreign earnings (within the specified maximums) currently received and to deny exemption to the portion of the earnings received after retirement. It would seem more logical to include the amount of the pension contribution with the other earnings currently paid to an employee and subject the combined amount to the $20,000 or $35,000 limitation, and allow exemption to the pension or annuity payments ascribable to these earnings.

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

SUMMARY

Section 13 should not be enacted

We believe that the principles of section 13 have no place in our tax structure, and that it should be deleted entirely. Its new concept of disregarding the corporate entity of entirely legitimate organizations would impose unwarranted burdens on American-controlled businesses operating abroad. It not only would constitute an unwise change in longstanding principles of the U.S. tax system, but would violate the spirit and intent of bilateral tax conventions negotiated and approved by the U.S. Senate. It will do injury to our foreign commerce, including exports from the United States and will substantially reduce tax revenues and injure our balance of payments on a longstanding basis.

Amplification of our views on section 13 begin below.

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

COMMENTS IN DETAIL

1. Section 13 will discourage foreign commerce and reduce exports from the United States.

The Committee on Ways and Means adopted on February 1, 1962, a far less drastic approach to the solution of the "tax haven" problem than is now contained in section 13 of the bill. We believe that the February 1, 1962, approach, with adequate enforcement by the Revenue Service under present and proposed information procedures would effectively stop "tax haven" abuses which concern the U.S. Treasury and which we do not condone.

The approach used in section 13 of the bill as passed by the House, does not limit itself to tax abuses but affects all business operations abroad, including long-established legitimate enterprises which under no circumstances could be classified as tax abuses. This broad approach can only lead to discouragement of U.S. private investment abroad with serious consequences to the U.S. economy. It will interfere with normal commercial transactions of U.S. businesses operating abroad through subsidiary operation and with international commerce generally, including U.S. exports. As one example, if a U.S. corporation had Canadian and French subsidiaries, the U.S. corporation would apparently recognize "foreign base income" from a transaction whereby the Canadian subsidiary sold goods to the French subsidiary, and the French subsidiary in turn sold to an unrelated person to Germany. With the existence of the European Common Market, there will be many such transactions made in the normal course of business.

In order to mitigate the penalties of application of the "foreign base company income" provisions to normal legitimate sales transactions, it would be necessary for a domestic corporation to incorporate a subsidiary in each of the foreign countries of the world where they may currently or subsequently make sales. Moreover, where, as is frequently the case, it is necessary to establish a separate subsidiary for political, legal, or other nontax business reasons, the receipt of income in the form of dividends from such subsidiary would result in immediate attribution of income to the ultimate 10 percent U.S. shareholder—unless the dividend is invested by the foreign parent corporation in a trade or business in a less developed country within 75 days of the year end. Certainly these arbitrary rules will affect a great many normal commercial transactions and have an adverse effect on U.S. foreign trade.

2. Section 13 introduces an entirely new and unwise concept into income tax law by disregarding the corporate entity where legitimate American foreign businesses are conducted through foreign corporations.

It has been said that the corporate entity can be ignored where it is found to be a "sham." However, section 13 of H.R. 10650, in effect, adopts an entirely new concept because it ignores the corporate entity whether or not it is a "sham" and imputes to a U.S. shareholder income earned by a presumed "controlled" corporation whether or not it can or does distribute such income to its shareholders. Moreover, arbitrary rules are set up to define "control" of a corporation by designating any 50 percent plus American-owned foreign corporation (owned by five or less U.S. shareholders) as a "controlled" foreign corporation and any 10 percent American owner of such corporation a "controlling" stockholder.

Imputing of income to shareholders, in other than "sham" situations, is a tax principle that has no precedent in the income tax system of any economically advanced country in the world. These include countries whose income tax statutes long predate the U.S. income tax system. It has been said that the United Kingdom system of mind and management is closely analogous to the provisions of section 13. This analogy seems faulty. The United Kingdom income tax system does not recognize arbitrary rules on share ownership, and gives full recognition to all phases of management and control—all basic actions necessary to conduct and operate a going business.

In the United Kingdom system the corporate income tax (standard tax) in effect is a tax on the shareholder and thus there is no real similarity with section 13.

We believe that it would be an unwise and regressive step in U.S. tax policy to disregard the corporate entity recognized under the present U.S. tax system. Adoption of this new principle with respect to foreign corporations would be discriminatory, since it is not generally applicable to all corporations.

3. Section 13 would prevent U.S. businesses abroad from competing on equal terms with similar businesses conducted by nationals of other countries; generally, these do not impose a home country income tax on subsidiary income from abroad as it is earned.

Most, if not all, of the economically advanced countries competing with American business in world markets afford positive tax incentives to their corporations and subsidiaries operating and trading abroad; for example, the United Kingdom overseas trade concept and the Holland (100 percent) and Belgium (80 percent) tax reductions for overseas income remittances. Section 13 will, by taxing (with few exceptions) reinvested income of American-owned foreign subsidiaries operating overseas and will place a new burden on such businesses which will put them at a serious competitive disadvantage with foreign-owned competition, and may cause our enterprises to lose their share of world markets. It appears that enactment of section 13 would involve the United States in "economic isolation." The Congress should provide competitive incentives and not place penalties on American competition. Legislation such as was contained in H.R. 5, the Boggs bill, 86th Congress, would provide these incentives and preclude "economic isolation."

4. Section 13 will prevent diversification of American business abroad.

Section 13 provides that (other than by investment in less developed countries) to qualify for nondeductibility income in excess of "foreign base company income must be reinvested in an already established similar trade or business within a developed country or after 5 years of seasoning in new business in the same geographic area." It is not clear what is meant by a similar trade or business, but it is amply clear that the proposal will deter American owners of businesses abroad from expanding operations beyond those already established prior to December 31, 1962. It may be assumed that this provision could be narrowly construed by the Treasury Department. Concern has been expressed that it may prevent a shoe manufacturer from deciding to make shoelaces, an auto manufacturer from deciding to make tires or a petroleum company from entering the chemical business. Of course, such businesses could qualify investment immediately by making them in an underdeveloped country. This, however, would frequently be quite unrealistic in the business, since because of remoteness of supplies, unavailability of labor, added transportation expenses, and lack of local markets, as well as exposure to exchange rules.

It seems that few businesses will be able to meet the requirements for investment of current earnings earned after 1963. The imposition of U.S. tax on such earnings unrealized by the U.S. parent will be a sufficient deterrent to either starting such businesses or to allowing them to grow and prosper in a normal manner. Accordingly, the competition will stultify the growth and perhaps destroy many U.S. businesses which must either distribute their earnings or accept an additional tax on U.S. earnings during the initial development stage.

It is evident that diversification of American businesses abroad will be severely restricted. In our opinion this is not in the best long-term interest of the U.S. economy.

5. Section 13 will violate the spirit and intent of 21 bilateral tax conventions negotiated by the U.S. Treasury and approved by the U.S. Senate and applicable to 44 countries of the free world.

For the past 40 years the U.S. fiscal authorities have negotiated tax conventions with foreign government for avoidance of double taxation. To date 21 such treaties have been ratified and approved by the Senate of the United States

after careful deliberation, public hearings, and recommendations by its Committee on Foreign Relations. All of these tax treaties have recognized that a corporation is a legal and separate entity and that such corporations have a recognized court support standing where a legitimate business purpose is served by its form of organization. Section 13 in imputing income to a corporation shareholder for U.S. income tax purposes does violence to the sanctity of the corporate entity and by so doing violates the spirit and intent of these tax conventions. Section 21 provides that H.R. 10650 overrides all treaty provisions. The Finance Committee should disapprove this unilateral action in abrogating long-established tax treaty principles.

It has been said that tax treaties are not affected by the proposals in H.R. 10650 to provide a U.S. tax on income earned abroad, since the tax is imposed on the U.S. parent corporation and not on the foreign subsidiary.

The rationale of this statement appears to be that since the form of the proposed law does not impose a tax on the foreign corporation per se, there cannot be a violation of treaty provisions.

This approach does not seem to be realistic. While the bill may be couched in this language, in many if not most cases the funds necessary to pay the U.S. tax so computed will have to be obtained from the foreign subsidiary by dividend or otherwise. The result would be at least that the U.S. corporation would pay a higher rate of tax on its income than is provided by the Internal Revenue Code. If the U.S. corporation incurred a loss for the year in question, attribution to it of income earned by a foreign subsidiary would result in effect in a tax on capital. The actual fact that the proposed law would impose a tax on the foreign subsidiary directly is also emphasized by failure to provide for current recognition of losses of such subsidiaries, and of carryforward or carrybacks of operating losses.

6. Section 13 will superimpose U.S. tax and accounting systems on foreign systems and create difficult and perhaps insolvable problems.

Section 13 concerns itself with taxable income of foreign controlled corporations and adjusted basis of qualified and nonqualified investments by a controlled foreign corporation. These terms are generally understood in the United States with respect to specific U.S. tax accounting rules. Presumably, these rules will be strictly applied in making income determinations for controlled foreign corporations even though accounting records are maintained by such foreign corporations under their own specific accounting and tax rules and principles. For example, depreciation deductions affecting income determinations and basis of investments will have to be redetermined for U.S. income tax purposes by a U.S. controlling shareholder, although different rules are followed abroad. Such information may not be available nor may the foreign corporations be willing to attempt to make such determinations at the behest of a U.S. shareholder, when there is a foreign minority interest. The U.S. shareholder will have to use his best judgment in reporting income and investment figures from available data which will conform to U.S. tax accounting rules and practices. U.S. taxpayers will be required to maintain auxiliary accounting records which may not be accurate under U.S. standards. No provision is made in section 13 for such contingencies. Directors of foreign corporations judge and report their results of operations on rules established in their own country and will not accept U.S. tax and accounting concepts in reporting to shareholders, American or otherwise.

It is our opinion that the U.S. tax and accounting system should not be superimposed on foreign systems and that legislation such as is envisaged by section 13, if required, should provide that generally accepted accounting practices in force in the foreign country be accepted for U.S. tax purposes.

7. Section 13 will cause foreign governments to raise their income tax rates at the expense of the U.S. Treasury.

Some countries are already considering appropriate action (e.g., Switzerland, Holland, Panama, and Columbia) to collect for their own treasuries the differential between the foreign and the U.S. income tax, by rate increases to absorb the differential. Accordingly, the United States will lose revenue gains expected by enactment of section 13. In fact, the tax revenues will ultimately suffer.

8. The provisions of section 13 are so complex that difficulty in administration is inevitable. Consequently, endless controversies and litigation can be expected with corrective legislation required.

Proposed sections 951 to 958 are extremely complicated and apparently have been drafted without adequate study and consideration. For example, under proposed section 952 a U.S. tax will be levied on income derived abroad from patents, copyrights, and exclusive formulas and processes which are substantially developed, created, or produced in the United States. This income may result from the use or exploitation by a controlled foreign corporation of such property right. The income from use or exploitation will be considered to be the amount which could have been received in an arm's-length transaction with in unrelated person.

Without adequate definition it is not possible to determine where such patents or processes were substantially developed, what constitutes an exclusive formula or process, or how an arm's-length determination of income could be made if such patent or processes were not usable by an unrelated person. American businesses, both here and abroad, are continually developing through research better and cheaper products in their established lines of business. To determine whether and how much income is derived from research inside and outside the United States is an impossible task.

The burden of proof in this situation will be on the U.S. taxpayer, and in this difficult area the taxpayer, short of litigation, has little defense against arbitrary determination by examining agents of the Internal Revenue Service.

9. Section 13 will tax currently certain annual income earned abroad but will not recognize current losses which would be available if incurred by a U.S. corporation.

There is no provision in section 13 to provide relief to U.S. controlling shareholders who must report their share of annual income not properly reinvested or distributed by a controlled foreign subsidiary, in the case of losses abroad. A subsequent year's loss would not be recognized to the U.S. controlling shareholder for U.S. tax refund purposes, since the section deals with annual taxable income increments. If it is assumed that this section is designed to place U.S.-owned foreign subsidiaries in the same position vis-a-vis a branch of a U.S. corporation, it is inadequate since a U.S. branch operation's losses are recognized in the computation of U.S. taxable income.

10. Section 13 will require U.S. shareholders to pay tax on imputed income before receipt even though upon actual receipt such income, because of foreign currency devaluations, may have been reduced or made valueless in U.S. dollar terms; there is no provision for refunding taxes previously paid.

Section 13 provides new rules in accounting for income earned by foreign-controlled corporations and gives no recognition of the fact that these earnings are received and accrued in foreign currency. If part of a foreign corporation's annual foreign earnings are imputed to a controlling U.S. shareholder and U.S. tax paid thereon, past history shows that it is entirely possible that a large portion of such imputed income could be extinguished by a sudden devaluation of foreign currency value. Thus, when a distribution is received of such foreign currency income and it is converted into U.S. dollar equivalent a substantial loss would be incurred. No provision has been made in this legislation for such loss or recognition of the resultant overpayment of tax.

11. Section 13 will severely hamper business investment abroad because of arbitrary (and changeable) distinctions between developed and underdeveloped countries where for sound management, business, and economic reasons U.S. foreign corporate enterprises operate across international boundaries.

Section 13 provides different tax effects as to developed and underdeveloped countries. This is an unfortunate approach since in many cases a business may operate across many boundaries and stimulate growth in all the countries in which it operates. To draw distinction between acceptable and inacceptable investments, country by country, for U.S. tax reasons seems unsound. The distinction provided is an oversimplification, since no clear expression is given as to the meaning of developed or underdeveloped countries, except that with limitation the countries in the latter category are to be announced by Executive pronouncement. This will create many uncertainties in business investment since what is "underdeveloped" today may be "developed" tomorrow. Under this tax concept an investor's tax liability can be materially changed by administrative fiat despite the fact that he acted in good faith on the understanding a particular country qualified as underdeveloped.

SECTION 14—GAIN FROM CERTAIN DISPOSITIONS OF DEPRECIABLE PERSONAL PROPERTY

1. PROPOSED SECTION SHOULD BE ADOPTED ONLY IN CONNECTION WITH OVERALL DEPRECIATION REFORM

The recommendations under this section are submitted to simplify and clarify the provisions and to eliminate inequities. However, our committee believes that the application of the proposal should be limited to gains resulting from "excessive" depreciation deductions, but in any event it should not be adopted apart from a program of overall depreciation reform. Moreover, the section considered alone is not consistent with the administration's stated policy for encouraging business to invest in new plant facilities.

While our committee approves the general proposition that "excessive" or "unrealistically high" depreciation deductions should not result in capital gain to taxpayers, it should be recognized that not all gains from disposition of depreciable property reflect recovery of excessive depreciation. The gain may be the result of inflation.

The treatment of gain on the disposition of depreciable property as proposed under section 1245, would be more acceptable if considered as part of the overall depreciation problem. The need for depreciation reform to provide for proper maintenance of investments in plant and machinery is essential to the development and well-being of the economy. Allowances for depreciation should keep pace with the decline in the value of the dollar to encourage replacement of obsolete and outworn equipment. Adoption of section 1245 without adoption of more liberalized depreciation allowances would only further discourage American management from replacing and investing in plant improvements.

2. SECTION 14(a)—PROPOSED SECTION 1245(a)(1)

Effective date

Ordinary income treatment is applied to dispositions of property after the effective date of the act, and is based on the depreciation allowed for taxable years beginning after December 31, 1961. This treatment should be made applicable only to property acquired after the effective date.

It is inequitable to subject taxpayers to the rules of this section with respect to property acquired prior to the effective date of the act. Where property was acquired prior to 1962, taxpayers in electing methods of depreciation, were not aware that gain on the eventual disposition of the property might be subject to ordinary income treatment. In electing methods of depreciation, taxpayers should be afforded the opportunity to evaluate all facts relating to the election at the time the election is made.

3. SECTION 14(a)—PROPOSED 1245(a)(2)

Recomputed basis

For the purpose of this section the term recomputed basis is defined to mean the adjusted basis of any property recomputed by adding back depreciation, "whether in respect of the same of other property" allowed or allowable to the "taxpayer or to any other person." The terms other property or other person should be clarified.

Since proposed section 1245(b)(3) excepts from ordinary income treatment, dispositions resulting from tax-free transactions, including transfers by gifts, it is clear that the ordinary income treatment proposed by section 1245(a) is intended to be applicable to property which is the subject of such transfers.

Also, the explanation of the bill as prepared by the Staff of the Joint Committee on Internal Revenue Taxation, states that "other persons" covers cases where "the basis of the property was carried over from the person from whom the taxpayer acquired it." There is no explanation in the statute of the meaning of "other property." For the purpose of clarity, the two terms should be specifically defined in the law, and in addition, section 1016 should be amended with regard to a transferee of depreciable property to require adjustments necessary to calculate "recomputed basis."

4. SECTION 14(a)—PROPOSED SECTION 1245(b)(2)

Transfers at death

This section excepts from ordinary income treatment transfers at death "except as provided in section 691." If a sale of property takes place before death which results in income in respect of the decedent, the property would not be transferred at death. Reference to section 691 is unnecessary and should be eliminated.

According to the explanation of the Staff of the Joint Committee on Internal Revenue Taxation, "where the sale has occurred before death and the income is treated as income in respect of a decedent under section 691," the transfer would not come under the exception of proposed section 1245(b)(2). Clearly, a sale before death is not a transfer at death, so that the inclusion of the reference to section 691 is confusing and unnecessary.

5. SECTION 14(a)—PROPOSED SECTION 1245(c)

Adjustments to basis

This section authorizes the issuance of regulations to provide for adjustments to the basis of property to reflect gain under proposed section 1245(a). The statute should specifically provide that where part or all of the gain has already been taxed as ordinary income as the result of a disposition, the recomputed basis should be adjusted for the income previously taxed as ordinary income to avoid duplication of ordinary income treatment.

Recomputed basis under proposed section 1245(a)(2) starts with the adjusted basis of property and adds depreciation, including that claimed by a different taxpayer or with respect to different property. Therefore, the same depreciation may be added to the adjusted basis of different taxpayers to produce ordinary income twice, or to the adjusted basis of different properties of the same taxpayer to produce the same result. For example:

(*a*) "A" transfers depreciable property to his wholly owned corporation in a transaction covered by section 351. Because of the receipt of boot, "A" has a recognized profit of $5,000 on the transaction which is taxed as ordinary income under proposed section 1245(a)(1). Subsequently, the corporation disposes of the depreciable property. In determining the recomputed basis, it would appear that the corporation might be required to add on "A's" depreciation as well as its own, even though "A" realized $5,000 of ordinary income on the exchange.

(*b*) "A" exchanges depreciable property for like-kind depreciable property plus $5,000 of boot in an exchange governed by section 1031. Under proposed 1245(b)(4), "A" would realize $5,000 of ordinary income on the exchange. Subsequently, "A" sells the depreciable property received in the exchange. The add-on to the recomputed basis of this property would seem to include the full depreciation claimed on the original property despite the realization of ordinary income by "A" on the exchange.

The statute should be clarified in order to show that the ordinary income, if any, realized on the subsequent sales in each of the above cases is decreased by the ordinary income realized on the prior exchanges.

6. SECTION 14(c)—PROPOSED SECTION 167(f)(2)

Salvage value

The liberalized salvage value rule applies to property acquired after the date of enactment. The new rule should apply in computing depreciation for taxable years beginning after December 31, 1961, with respect to property disposed of after the effective date of the act.

Where the property is disposed of after the effective date of the act, the excess depreciation resulting from the reduced salvage value will be subject to ordinary income treatment regardless of when it is acquired. Since "recomputed basis" is computed by adding to adjusted basis, the depreciation allowed for taxable years beginning afer December 31, 1961, the liberalized salvage value should be applied in computing such depreciation.

If the ordinary income treatment of proposed section 1245(a)(1) were to apply only to property acquired after the effective date of the act, as recommended in 2 above, this recommendation would not be necessary. Under these circumstances, the liberalized salvage value should apply only to assets acquired after the effective date of the act.

7. SECTION 14(e)(4)—PROPOSED SECTION 341(e)(12)

Collapsible corporation

In determining whether a corporation is collapsible, under sections 341(c) and 341(e), the adjusted basis of assets is used in applying the various percentages referred to in the sections. All such references to adjusted basis should be changed to "recomputed basis."

Under the collapsible corporation provisions of sections 341(c) and 341(e) reference is made to the adjusted basis of assets. Since a corporation may be subject to ordinary income treatment on proposed section 1245 assets when it disposes of these assets, the noted sections should be amended so that "recomputed basis" is used where applicable. Thus, the presumption that a corporation is collapsible under sections 341(c) should only apply if the fair market value of the property exceeds 120 percent or more of the "recomputed basis."

8. SECTION 14(e)(4)—PROPOSED SECTION 341(e)(12)

Collapsible corporation

In computing gain from sale or exchange of stock of a collapsible corporation, under section 341, ordinary income treatment may be applied to the shareholder without regard to the application of proposed section 1245(a) to the corporation. This should be amended to permit capital gain treatment on gain which is or will be taxed under proposed section 1245(a).

Where a collapsible corporation is liquidated or its stock is sold, the stockholders may be subject to ordinary income treatment under section 341. In addition, the corporation could be subject to ordinary income treatment under proposed section 1245(a) at the time of liquidation or when the corporation otherwise disposes of assets. To mitigate the harsh result that this imposes, where section 341 is applicable, the shareholders should be permitted capital gain treatment to the extent of the gain attributable to the proposed section 1245 assets, reduced by the corporate tax applicable to the income subject to proposed section 1245(a)(1).

SECTION 15—FOREIGN INVESTMENT COMPANIES

1. SECTION 15(a)—PROPOSED SECTION 1246(c)

Taxpayer to establish earnings and profits

It may not be possible for a taxpayer to establish the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held stock in the company.

Proposed section 1246 provides that when an investor sells his stock in a foreign investment company (which either is registered in the United States or principally owned in the United States) the portion of his gain attributable to accumulated earnings and profits of the foreign investment company after 1962 will be taxable as ordinary income.

The burden is placed upon the taxpayer to establish the amount of accumulated earnings and profits for the period that he held the stock in the foreign investment company. However, the term "earnings and profits" is not defined in the Internal Revenue Code nor is it clear in the code or in the proposed bill what rules will be applicable in the determination of earnings and profits. Will the U.S. tax rules apply?

2. SECTION 15(a)—PROPOSED SECTION 1246(e)

Stock acquired from a decedent

The basis of stock acquired from a decedent should be reduced only to the extent of the decedent's ratable share of earnings and profits accumulated since December 31, 1962. Also the provision should not apply to earnings and profits accumulated after December 31, 1962 which were subject to an election under proposed section 1247.

The proposal requires the reduction of the basis of stock of a foreign investment company acquired from decedent by the amount of the decedent's ratable share of the accumulated earnings and profits of such company. It would appear that in order to correlate the treatment on stock passing through an estate with that relating to stock sold during the life of the holder, it would be

necessary to restrict the reduction in basis to the earnings and profits accumulated since December 31, 1962. Also, it would appear appropriate to provide that the reduction in basis should not apply with respect to earnings and profits accumulated after December 31, 1962 which were subject to an election under proposed section 1247.

3. SECTION 15(a)—PROPOSED SECTION 1247

Capital gain dividends

To rectify what probably was an unintended omission, a provision similar to the "capital gain dividends" provision for regulated investment companies should be added to the foreign investment companies proposal. Capital gain dividends may be treated as long-term capital gains by shareholders of regulated investment companies.

Proposed section 1247 provides a technique for a registered foreign investment company to elect tax treatment which is probably intended to be substantially identical with the tax treatment of a U.S. regulated investment company. This should mean that ordinary dividends would be taxed as ordinary income and there would be a "pass through" treatment for capital gains. However, as discussed below, this result is not achieved as to capital gain dividends actually distributed.

Proposed section 1247(c)(2) clearly authorizes a qualified shareholder to treat the undistributed net long-term capital gains of an electing foreign investment company as long-term capital gains in his own return. However, if an electing foreign investment company distributes any of its net long-term capital gains to its shareholders, the distribution would be ordinary dividends taxed as ordinary income. The proposal does not contain a provision comparable to section 852(b)(3)(B) relating to capital gain dividends of domestic regulated investment companies. Shareholders of regulated investment companies may treat capital gain dividends as long-term capital gains. A similar provision should be added to section 1247 since its omission probably was unintended.

SECTION 16—GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

1. SECTION 16—GENERAL COMMENT

Proposed provision unnecessary

There does not appear to be any reasonable foundation for the proposals with respect to tax treatment of gain realized on sale or exchange of shares as provided in section 16 of the bill. The proposals go much further than any mere effort to equate the U.S. tax consequences of operations abroad through foreign corporations with similar operations through a U.S. corporation.

The proposed changes provided by section 16 of the bill would tax certain U.S. shareholders in full on gain realized upon sale or exchange of stock in a foreign corporation. This section of the bill goes much further than any mere effort to equate the U.S. tax consequences of operations abroad through foreign corporations with similar operations through a U.S. corporation. The provisions in section 16 discriminate against the use of foreign corporations quite apart from any motives which may be attached thereto. Other parts of the bill (e.g., sec. 13) go to great lengths to assure that all income deemed attributable to U.S. sources will be taxed to the U.S. shareholders and that foreign corporations will not be permitted to accumulate income except for reinvestment to a highly limited degree. Accordingly, there does not appear to be any reason for the proposals with respect to tax treatment of gain realized on sale or exchange of shares as provided in section 16.

The provisions would create particular hardship in cases where sales of stock in foreign corporations are forced by nationalistic policies or laws of certain foreign countries. It would also unjustly tax at ordinary rates gains which would otherwise be subjected to a single capital gains tax except for the reason that the corporation is a foreign corporation. For example, if a corporation in Canada, or the United Kingdom had distributed currently all of its earnings and profits over a long period of years but in connection with a liquidation its properties were sold, any gains realized by the corporation would be included in earnings and profits thus subjecting the gain to the shareholders upon liquidation

to ordinary tax in the United States even though except for the capital gain on the sale of the properties, there would have been no earnings and profits.

Suggested modification

Although we oppose section 16 and believe that a deviation from the normal treatment of redemptions, sales, and exchanges is unnecessary, the proposed section 1248 would be less inequitable if, to the extent of ordinary income treatment required, the treatment would be that of a dividend for all purposes, and a foreign tax credit and foreign tax deemed paid credit, would be allowed both to the corporation and individual shareholders for both redemptions and sales or other exchanges. However, the tax, in any event, would not be less than the tax that would apply if proposed section 1248 were not applicable.

Following are specific problems under the proposal:

2. SECTION 16(a)—PROPOSED SECTION 1248 (a) AND (b)

Redemption, liquidation or sale of stock

The tax treatment of gains should be the same whether the disposition of stock is by redemption, liquidation, or sale.

Section 1248(a) would include in the gross income of the U.S. shareholder, as a dividend, the shareholder's proportionate part of the earnings and profits accumulated after February 28, 1913. In view of the generally prospective effective dates contained elsewhere in the bill, this retroactive attack on earnings and profits accumulated in prior years seems unwarranted.

There does not appear to be any reason to distinguish for tax treatment purposes gains realized upon redemption or liquidation from gains realized upon sale or exchange—by taxing the shareholder in the first instance on his proportionate share of all accumulated earnings but limiting the impact in the second instance to the earnings accumulated during the short period of ownership. Equitably the impact should be limited in both instances to the earnings accumulated during the period of ownership.

3. SECTION 16(a)—PROPOSED SECTION 1248(c)

Limitations

Hardships will be created by application of constructive ownership rules of proposed section 955(b) together with the proposed 5-year rule and the 10-percent ownership rule under proposed section 1248.

The application of the constructive ownership rules of proposed section 955(b) together with the 5-year rule provided in proposed sections 1248(c) (1) and (2) are bound to create hardship situations. The 10-percent rules in proposed section 1248(c)(2) when separated by as much as 5 years from the "control" limitation in proposed section 1248(c)(1) could be brought into play in such a variety of ways that the possibilities are inexhaustible.

The provisions of proposed section 1248(c)(3) limit the amount of earnings and profits taken into account for proposed section 1248 purposes by excluding amounts previously included in gross income under proposed section 951. This exclusion, however, is limited to the person making the sale or exchange. Conceivably a substantial amount of the earnings of the foreign corporation could have been taxed to other shareholders so that the same earnings and profits are attributable to more than one U.S. taxpayer.

4. SECTION 16(a)—PROPOSED SECTION 1248(d)

Taxpayer to establish earnings and profits

It is unfair to place the burden of determination of the earnings and profits of the foreign corporation on the taxpayer particularly when "earnings and profits" is not defined in the code or in the bill.

This section places the burden of determination of the earnings and profits of the foreign corporation on the taxpayer. However, the term "earnings and profits" is nowhere defined in the Internal Revenue Code nor is it clear in the code or in the proposed bill what rules will be applicable in the determination of ernings and profits. (Will the U.S. tax rules apply?. If so, must the income be reconstructed since 1913 giving effect to all of the different U.S. tax rules which have been in effect since then?) The proposed amendment does not indicate in what fashion the taxpayer must establish the amount of the

earnings and profits. Accordingly, this places a virtually impossible burden on the taxpayer and may be looked upon as a means of forcing a taxpayer to treat the entire gain as ordinary income.

SECTION 19—WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

1. SECTION 19—GENERAL COMMENT

Withholding may be unnecessary

> The taxpayer identification numbering system and the establishment of automatic data processing in the Service appear to make unnecessary the adoption of a withholding system. Also the compliance costs to the business community and to the Government will be heavy.

We are aware that the Internal Revenue Service is installing its ADP system by regions, and that all parts of the country will not be fully covered for some time. However, the Service is actively engaged in a publicity campaign, through news releases, speeches by the Commissioner and others, etc., to warn all taxpayers to examine their reporting practices to be sure that all taxable income (including specifically dividends and interest) are reported on returns for 1961 and subsequent years. It is obvious that the Commissioner himself feels that the mere authority granted by the Congress to establish a numbering system for taxpayers, and the potential of the ADP system to ferret out omissions of taxable income in the dividend and interest area particularly, will go a long way to reducing or substantially eliminating the reporting gap. We believe it is abundantly clear that the considerable publicity given to the capabilities of these reporting systems is by itself having a very significant effect on taxpayer compliance, and that by this activity alone the underreporting is being greatly reduced.

It seems to us that the campaign to warn people of the capabilities of the ADP system can by itself improve compliance to a greater degree than the Service actually accepts as obtainable.

Should the Congress in its judgment decide that a system of withholding on dividends, etc., must be established, following are some observations on the provisions of the proposal.

2. SECTION 19(a)—PROPOSED SECTION 3461(c)

Amount of dividend unknown

> The withholding agent should be relieved of any liability for the payment of taxes required to be withheld when he determines in good faith that a distribution is not a dividend.

Withholding agents would be required to compute tax on the entire amount of a distribution where the agent "* * * is unable to determine the portion of a distribution which is a dividend * * *." Where a corporation pays a dividend at a time when it does not have prior accumulated earnings or profits, a withholding agent would have a difficult time determining the status of the distribution. The status of the distribution may not be determinable until the end of the taxable year, or in the case of audit adjustments not until some time thereafter.

In view of the liability imposed on the withholding agent under proposed section 3481, proposed section 3461(c) would require withholding where there was any chance that a ditribution might, at some future date, be defined as a dividend. Either proposed section 3481 or proposed section 3461(c) should be amended to relieve the withholding agent of liability when he determines in good faith that a distribution is not a dividend.

3. SECTION 19(a)—PROPOSED SECTION 3483

Exemption certificates

> The provision for exemption certificates seems unnecessary in view of the quarterly refund procedures. It would place an undue burden on the withholding agent.

Exemption certificates may be filed by anyone who "* * * reasonably believes that he will not * * * be liable for the payment of any tax * * *." The provision for exemption certificates seems to place an undue burden on the with-

holding agent, and it hardly seems necessary in view of the quarterly refund provisions of proposed section 3484. Moreover, it does not seem appropriate to place the recipients of interest and dividends in a preferred position as compared to individuals having wages subject to withholding.

The expense to the agents in processing exemption certificates and the expense to the Government in verifying the propriety of the certificates would seem to outweigh any advantage which might accrue as the result of establishing a system of exemption certificates. The burden to the Government will also be great because of filing of improper exemption certificates, either fraudulently or because of ignorance on the part of taxpayers, particularly in view of the provision that the Treasury will continue to make refunds in future quarters unless the stockholder notifies it of a change in exemption status.

SECTION 20—INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

1. SECTION 20(a)—PROPOSED AMENDMENT TO SECTION 6038

Information to be furnished by individuals, domestic corporations, etc.

Very broad powers would be granted to the Secretary or his delegate regarding information to be furnished with respect to certain foreign corporations. The proposals are more complex and onerous than existing statute and the proposed extension of the concept of "control" could create many problems in the submission of data and information not necessarily needed with respect to foreign corporations. Moreover, the penalty for failure to comply is severe in relation to information requirements.

The Secretary or his delegate would have the right under the proposals to require a taxpayer to furnish "any other information which is similar or related in nature to that specified." This new element seems unnecessary in view of the full disclosure which is required under present law and which may be prescribed by regulations. Because of the severe penalties (through reductions of foreign tax credits otherwise allowable) which would be imposed in the case of failure to comply with all the requirements with respect to any "foreign corporation," all additional information required should be specified by statute if it is to be required at all.

Present law and the proposed law impose penalties without regard to any intended avoidance of tax and thus may be considered punitive. A wholly inadvertent failure to accurately and completely furnish the required information could result in a penalty. Where there is no willful failure to furnish the information no penalty should attach. Civil penalties could be related to the tax avoided. The arbitrary reductions in tax credits called for by any failure on the part of the "U.S. person" are beyond the needs of enforcement.

The proposals relating to (*a*) ownership rules, not merely holdings of record, (*b*) application of constructive ownership rules, and (*c*) details with respect to reporting and circumstances under which "persons" qualify or do not qualify within the many requirements are complex. Complexities to the development of the information will burden industry without real benefit to the Secretary.

2. SECTION 20(b)—PROPOSED AMENDMENT TO SECTION 6046

Information as to organization or reorganization of foreign corporations, etc.

The reporting requirements should be confined to stockholders, and not to officers or directors.

It seems particularly inappropriate to require filing of information by a person solely because he is a U.S. citizen. Many U.S. citizens are officers or directors of foreign corporations which have no business relations at all with U.S. enterprises, or only a minimum of such U.S. connections. Furthermore, even resident citizens who are employees of a U.S. corporation controlled by a foreign corporation may for legitimate business reasons be an officer or director of the foreign corporation. Certainly this will be so with aliens resident in the United States. In such cases the U.S. citizen or resident is unlikely to be even aware of the reporting requirements proposed, and it is unlikely that he will be able to obtain the information required by the Secretary or his delegate.

We recommend that the requirements of section 20(b) be limited to persons with the requisite stock interest in the foreign corporation. The requirement for reporting by 5 percent or more stockholders should be sufficient to provide necessary information to the Treasury Department.

3. SECTION 20(C)—PROPOSED SECTION 6678

Civil penalty for failure to file return

A civil penalty would be imposed for failure to file a return under section 6046 regardless of whether failure to file was due to "willful neglect." Under present law, section 7203, sufficient penalty is imposed for willful failure to file a return.

An additional penalty should not be imposed because of the other penalties already in the code. Should section 6046 be amended as proposed, many shareholders could unknowingly fail to comply with the reporting requirements. This would be a very severe and unwarranted penalty.

SECTION 21—TREATIES

1. SECTION 21—APPLICABILITY OF SECTION 7852(d)

Nonapplicability of treaty obligations

We believe this "shotgun" approach to abrogation of treaty provisions will prove to have an unfortunate effect on future negotiations of tax treaties.

Assuming the bill is enacted in substantially the form proposed and that this results in conflict between existing treaty provisions and some of the provisions of the bill relating to taxation of distributions by foreign trusts and taxation of the income of controlled foreign corporations, the solution of this problem should be approached on a selective and section-by-section basis. Over the years the practice of negotiating tax treaties with various countries has assumed increasing importance. The proposed amendment of section 7852(d) in this peremptory manner may have serious repercussions in terms of raising questions as to the good faith of such negotiations when they can be negatived by a one-sentence provision in a subsequent revenue bill.

In any event, the proposal should be made by amendment to the code and not merely by interpretation of section 7852(d).

The CHAIRMAN. The next witness is Mr. Joseph R. Barnes of the Illinois Manufacturers' Association. Take a seat, Mr. Barnes, and proceed.

STATEMENT OF JOSEPH R. BARNES, ILLINOIS MANUFACTURERS' ASSOCIATION

Mr. BARNES. For the amazement of the committee, I only have a 5¼-page statement here, double spaced.

Mr. Chairman and members of the committee, my name is Joseph R. Barnes. I am the director of the tax department of the Illinois Manufacturers' Association. Unfortunately the expert witness originally scheduled to present this statement to you found it, at the last moment, impossible to be present here today. However, I am here to read to you his prepared statement which reflects the views of the Illinois Manufacturers' Association with respect to House bill 10650.

Section 2 of the House bill provides a credit for investment in depreciable property. Briefly it is provided that at the top limit 7 percent of the cost of qualified investment may be taken as a credit against Federal income tax liability, limited to the tax liability or, if such liability should exceed $25,000, then 25 percent of such amount. There is a 5-year carry forward for unused credit.

We believe that this is an expedient to adjust effective tax rates whereas there should be fundamental, long-term liberalization of depreciation. For businesses that are presently hard pressed for cash, the credit incentive for investment does not offer an immediate means for expansion or modernization of facilities. This provision quite certainly provides a windfall for large corporations who have adequate

financing and whose expansion and modernization programs will not be significantly affected by the incentive investment credit. Thus, we believe that big business will be more greatly benefited than will medium and small business.

Now, because rates of depreciation are always the subject of review by the Internal Review Service and frequently lead to disputes, so will the amount of credit provided by section 2 of House bill 10650 be subject to review and to dispute, because the credit is tied to depreciable lives of qualified investments. This can mean that taxpayers will be uncertain of the actual amount of credit for long periods of time. This is undesirable and expensive. It is our belief that these undesirable results can be avoided and the objectives of the investment credit achieve by liberalization of depreciation. Also, such liberalization would eliminate a large area of dissension between taxpayers and the Internal Revenue Service as to salvage value and lives of assets.

This brings us to our position on the ordinary income tax treatment of gains from the sale or disposition of depreciable property as provided by section 14 of House bill 10650. We would approve of such treatment only if it is a part of a program to liberalize depreciation.

Section 4 of House bill 10650 provides for amendments to code section 274 and covers the disallowance of certain entertainment expenses, and so forth.

As for these amendments, we believe they are unnecessary. We agree with the Internal Revenue Service that there are presently abuses. However, we are not convinced that the proposed legislation will eliminate them. We believe that the abuses can only be mitigated by more tax returns being audited. This we know is the objective of the Internal Revenue Service and will be realized to a large extent when it has in full operation the EDP program recently started.

Section 19 of the House bill 10650 provides for withholding of income tax at source on interest, dividends, and patronage dividends.

As you are well aware, industry and business for the most part is strongly opposed to this section of the House bill 10650. The membership of the Illinois Manufacturers' Association is also opposed to this legislation.

It has been said that the job of withholding on interest and dividends will not be any more difficult or any more expensive than withholding on salaries and wages. We think this is not correct. For one thing, there is not the close relationship and control over the stockholder in a medium or large corporation or the depositors in a medium or large bank that exists in the case of the employee. Thus, more time and paperwork will be required to administer the program. Again, legislation is being proposed which takes away from the productive time and effort of business and adds to its burden of operations.

As with the travel and entertainment expense legislation proposed in section 4 of the bill, more complex laws are being added to an already complex code of taxation by the dividend and interest withholding provisions. This additional administrative job is to be borne by industry and business at its sole cost. It has been said that business would receive compensation for its job of withholding because it has the use of the withholdings of interest and dividends for a period of time before such withholdings are deposited. Evidence has been

given to the effect that in the case of a suburban bank, it would earn less than 10 cents annually per savings account on the retained withholding as provided by House bill 10650.

Thus it is that business under the interest and dividend withholding provisions of this bill is required to take on added fixed overhead expense that does nothing to maintain or increase its profits. Here, we believe, is an area where the educational campaign started some time ago by the Treasury Department in cooperation with business is causing taxpayers properly to include in their tax rturns dividends and interest. This problem is also one which can be practically eliminated by audit of additional tax returns which will be done under the Internal Revenue Service's EDP program.

While time does not permit us to detail our objections to those sections of House bill 10650 which provide for the current taxation of earnings of foreign corporations owned by U.S. persons, we do want to go on record as opposed to such proposed legislation.

We should like also to record the fact that we do favor those parts of the bill which provide for the taxation of cooperatives. We believe this is desirable because cooperatives without this legislation have an unfair competitive advantage with the rest of the industries of which they have become an important part.

Another matter which is of concern to our association members is that we understand that amendments to House bill No. 10650 will be offered in the Senate which would eliminate the $50 dividend exclusion and the 4-percent dividend credit against the income tax of individual taxpayers.

We wish to be on the record as opposed to such amendments. The dividend exclusion and the 4-percent credit is a step in the direction of removing the double taxation of corporate dividends. We believe such provisions encourage the taxpayer to more freely invest in American enterprise.

Thank you for the opportunity to present our views.

The CHAIRMAN. Thank you very much, Mr. Barnes. Are there any questions?

Senator MCCARTHY. Mr. Chairman, I would ask one question about the last statement.

Dr. Barnes, you said you are concerned about the double taxation which results from the taxation of dividends as ordinary income. Could you tell me why, when you considered this along with the extension of the corporate profits tax, spokesmen such as you did not simply advocate that we reduce the corporate profits tax and not bother to complicate the code by dealing with this special dividend credit?

You are for a simple code. You don't like complexities in terms of double taxation. You would have gained just as much if you had come in and said, "Let's cut the corporate profits tax by 1 percent, and not complicate the code and the tax returns with the dividend credit."

Mr. BARNES. Perhaps here, Senator, we are grasping at straws in trying to keep what we have got.

Senator MCCARTHY. You didn't have it. You were trying to get what you didn't have. But in terms of the principle of double taxation which you invoke, it shouldn't have made any difference.

Mr. BARNES. We have long been on record as favoring a reduction in corporate and personal income taxes.

Senator McCarthy. I know you are on record against every tax. This is the kind of a problem we have. You know everybody is for a balanced budget, but when you get to dealing with taxes, they are against every specific tax.

When we go to appropriations, everybody is against appropriations in general, but they are for every specific appropriation, and we have to kind of try to balance this thing out. The taxes we impose are specific taxes. It makes it tough.

You should never campaign too hard against the members of the Finance Committee, I should think, Mr. Chairman, because we might panic when we get back.

I wish the national association would try to reconcile what seems to me to be kind of an unexplained contradiction between their general support for the continuation of the corporate profits tax rather than to drop that tax and eliminate this dividend credit provision.

Mr. Barnes. I don't believe that we are on record as favoring a continuation of the present corporate income tax.

Senator McCarthy. You are on record as being against double taxation. My question is: If this is your principle, you would be just as well off if we simply reduced the corporate profits rate rather than give you a dividend credit which complicates the whole tax structure and the reporting procedures.

I would like an explanation as to why you don't simply concentrate on the one, say, in terms of amounts. You would get just as much by reducing the corporate profits rates and not bother to complicate this with dividend credit. I don't expect the answer today, but I hope at some future time we might have this explanation.

(The explanation requested will be furnished Senator McCarthy at a subsequent date.)

The Chairman. Thank you very much, Mr. Barnes.

The next witness is Mr. Raymond A. Hoffman, of the Illinois State Chamber of Commerce. Proceed, Mr. Hoffman.

STATEMENT OF RAYMOND A. HOFFMAN, ILLINOIS STATE CHAMBER OF COMMERCE

Mr. Hoffman. My name is Raymond A. Hoffman. I am a partner in Price Waterhouse & Co., a firm of certified public accountants.

This statement is presented on behalf of the Illinois State Chamber of Commerce, a statewide organization with a membership of more than 18,000 businessmen in 418 communities in every part of the State of Illinois. The members are engaged in virtually every type of business and range from the self-employed to those associated with some of the Nation's largest corporations.

The recommendations which will be presented in behalf of the State chamber, were prepared in the first instance by the State chamber's Federal taxation committee of 76 members and were subsequently endorsed by the State chamber's 70-member board of directors. The viewpoints presented broadly represent those of Illinois business with respect to H.R. 10650. I have personally been a member of the State chamber's Federal taxation committee for over 10 years, and have served as the chairman of its subcommittee on technical problems. Before turning to the specific provisions of that bill I should

like to make some general comments that impress us as being of basic importance in any consideration of tax policy.

GENERAL COMMENTS

The Illinois State Chamber of Commerce regards present high rates of income tax as producing many undesirable consequences. These rates, both for corporate and individual income, impair incentives to work, produce, and invest.

High rates also cause many decisions to be made in consideration of tax results rather than on the basis of sound business reasoning. Moreover, the high rates have impelled Congress to adopt various tax-relief provisions that would not be otherwise necessary and that have added greatly to the complexity of the tax law. Because of these and other difficulties created by present rates the rate-reduction program of the Herlong-Baker bills is advocated in principle.

Mr. Chairman, our written statement covers eight of the substantive sections of H.R. 10650 as reported by the House Ways and Means Committee. These particular sections were selected because they contain issues of special concern to business in Illinois, and are as follows:

Section
2. Investment credit.
3. Appearances, and so forth, with respect to legislation.
4. Disallowances of certain entertainment, and so forth, expenses.
13. Controlled foreign corporations.
14. Gain from dispositions of certain depreciable properties.
17. Tax treatment of cooperatives and patrons.
19. Withholding on interest, dividends, and patronage dividends.
20. Information with respect to certain foreign entities.

SECTION 2—INVESTMENT CREDIT

Recommendation: In lieu of enacting the complicated, discriminatory provisions of section 2, encourage the needed expansion and modernization of manufacturing plants and equipment by amending the code to permit the use of a "bracket" system for determining useful lives of depreciable property.

Senator McCARTHY. What does that mean?

Mr. HOFFMAN. The bracket system of depreciation is similar to what has been used in Canada, that is to provide by legislation a range of depreciation rates that could be used for certain classes of property. The taxpayer would have the option of choosing a depreciation rate within that range.

Explanation: Expansion and modernization of the Nation's productive plant are important to supply the jobs and to make the products essential for an increasing population. In addition, such expansion and modernization will permit more effective competition with products of new foreign plants.

Though there is widespread agreement as to those objectives, there are differences of opinion as to how they can best be achieved. Clearly, however, the tax treatment of depreciation is an important factor, and certain principles seem to be basic:

1. Management should have maximum discretion in writing off investments in depreciable property.

2. Requiring the recovery of cost to be stretched out over an excessively long period of time discourages expansion and modernization.
3. Further expansion would be encouraged by liberalization of depreciation allowances based upon established income tax and accounting concepts understood by management.
4. Novel incentive devices should not be used when conventional measures are available.
5. Recovery of an investment should be sufficiently rapid to minimize the impact of inflation, whether the investment is 100 percent or 93 percent of the machinery manufacturer's invoice price.

The administration's announcement that it will permit depreciation allowances to be based upon shorter useful lives in the textile industry in certain situations and that it contemplates action in other industries will not bring forth the widespread modernization and expansion of productive facilities which a specific statutory liberalization will induce.

Years ago taxpayers were assured that their depreciation allowances would not be challenged unless there was a "clear and convincing" basis. Nevertheless, businessmen have found that revenue agents frequently apply arbitrary standards in determining what is "clear and convincing." A similar situation could develop with respect to any liberalization of depreciation by administrative action. When returns covering current periods are audited several years from now, taxpayers currently embarking upon a costly expansion or modernization program will not be protected unless liberalization of depreciation is brought about by statutory amendment.

The investment credit approach is inequitable because it reduces taxes imposed upon the income of a restricted group—those persons investing in certain types of properties during 1962 and such subsequent years as the credit may remain in effect. It discriminates against the taxpayer who expanded or modernized his facilities in 1961 or some prior year. Further, it is discriminatory in that it does not apply to investments in buildings, and provides for an arbitrary scale of percentage allowances based upon the useful life of each asset—with full credit for property having a useful life of 8 years or more, whether the life is estimated at 8, 12, 16, 20, or some other number of years.

Advocates of the investment credit have stated that it would stimulate economic growth. This claim is subject to question because, first, the credit applies whether or not it actually influenced the taxpayer in his decision to acquire a facility, and, second, the amount is small in comparison with the total investment required to maintain a business. The investment credit—whether it be 7 percent, 8 percent, or even 10 percent of the cost of the tangible personal property having a useful life of 8 years or more—will be small in relation to the capital needed to house and fully equip an operating unit of a business and to finance the payrolls, inventories, and accounts receivable.

A discriminatory, limited investment credit is merely an income tax reduction for those who qualify for it. Actually, the best stimulant to economic growth in this country would be a reduction in income tax rates. If such reduction is not now possible in the judgment of the Congress, adoption of the "bracket" system of basing depreciation allowances would be a broader and more effective stimu-

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lant to economic growth than the proposed credit. In addition, it would satisfy simply and expeditiously some of the needs for depreciation reform discussed by Treasury Secretary Dillon before the Joint Committee on Internal Revenue Taxation on January 18, 1962.

SECTION 3—APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

Recommendation: In lieu of enacting section 3 of H.R. 10650, adopt the principles of H.R. 640 introduced January 3, 1961, by Mr. Boggs.

Explanation: In a statement addressed to the Commissioner of Internal Revenue November 12, 1959, in relation to then-proposed regulations, the Illinois State Chamber of Commerce described its activities in supplying information to the business concerns comprising its membership. Such information relates to complex legislative issues of direct concern to business. The chamber's statement also pointed out that it seemed inconsistent to require a chamber of commerce exempt from income taxes under the provisions of the code to evaluate its detailed activities in an attempt to segregate certain lobbying expenditures. H.R. 640 seems to eliminate the difficulties. That bill prohibits tax reduction for political contributions or for costs of participating in any political campaign. These provisions offer adequate safeguards.

By contrast H.R. 10650 appears further to complicate, rather than clarify, the present situation. Among other things, this bill raises doubts about the tax treatment of expenditures incurred for disseminating information to the public. Also, in the case of dues to membership organizations, this bill imposes the virtually impossible task of ascertaining what portion of the organization's activities are on account of appearances and communications to legislative bodies.

SECTION 4.—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Recommendation: Improvement in reporting business expenses should be sought through the present program of the Internal Revenue Service rather than by statute; further, no "ordinary and necessary" business expenses should be arbitrarily disallowed so long as they are not contrary to public policy.

Explanation: The Internal Revenue Code presently provides adequate standards for the determination of the deductibility of business expenses, and its provisions can be enforced by adequate review procedures which should be improved, if necessary. Enactment of specific rules would only complicate and retard the review process.

In 1960 the Internal Revenue Service announced a threefold program of stricter checking to deal with abuses involving business entertainment, travel, and similar expenses: (*a*) new reporting requirements for employers, (*b*) encouragement of adequate employee accounting practices, and (*c*) instruction to field offices to place increased emphasis on the examination of returns involving the expenses. The effectiveness of these procedures has not yet been tested; consequently, legislation would appear premature.

Entertainment involves ordinary and necessary business expenditures, and is an accepted and legitimate method of business promotion. It is among the few means of business promotion available to

lawyers, accountants, doctors, and other professional groups that are restrained from advertising and solicitation by ethical considerations. It is inequitable to use tax legislation to destroy a method of doing business merely because of extreme situations which can be corrected by enforcement procedures.

It has been stated that under present conditions the review of travel and entertainment expenses is difficult and time-consuming to all concerned, often involving detailed examinations of records and reconstruction of inadequately substantiated expenses. Much the same contentions could be made with respect to other areas of frequent disagreement between the Internal Revenue Service and taxpayers, such as depreciation and obsolescence allowances, abandonment losses, repairs versus capital expenditures, valuations in connection with basis problems and gift and estate tax matters, hobby losses, and in many other areas where factual determinations are necessary. It would be easy to solve all of these problems by making restrictive laws which would have the effect of disallowing legitimate deductions and losses, but this would destroy the basic concept of taxing *net* income, which, in substance, means gross income minus all expenses and losses attributable to the production of that income.

The report of the Committee on Ways and Means expressly states that the proposed section 274—

disallows, in whole, or in part, certain expenses which would be fully deductible under present law.

Consequently, a proven expenditure which admittedly constitutes—

an ordinary and necesary expense incurred in carrying on a trade or business—

would be disallowed. In the past, such an expense would be taken into account in computing taxable income except where its payment or allowance was contrary to public policy. Disallowance of legitimate deductions for any other reason is completely unjustified.

Further, it is proposed to change the parenthetical clause in the Internal Revenue Code indicating the scope of allowable traveling expenses from "including entire amount expended for meals and lodging" to "including a reasonable allowance for amounts expended for meals and lodging." The report of the Committee on Ways and Means states the proposal is intended to reflect the position taken in the Treasury regulations for many years. The sentence in the regulations reads:

Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted.

The proposed statutory language may be susceptible of a broader interpretation than that in the regulations; if it is not intended to be broader, there is no need for the amendment. The Internal Revenue Service may be in the position of being able to say that $15 is a reasonable allowance for a hotel room even though $18.75 was actually expended.

The proposed legislation relative to expenses for travel, entertainment, and business gifts is opposed because:

1. The Internal Revenue Code presently provides appropriate standards for administrative solution of the problems cited as reasons for the legislation.

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2. Legislation in this area is at least premature in view of current administrative action.

3. Entertainment is legitimate business practice, and tax legislation should not purport to deny its status.

4. By imposing such objective tests as an arbitrary $25 limitation on business gifts the bill presumes to question the right of businessmen to exercise their individual judgment in making expenditures believed to be helpful in increasing business volume and income.

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

Recommendation: Do not make undistributed income of foreign corporations subject to tax.

Explanation: The bill would destroy, for tax purposes, the foreign corporation's separate existence. Income accumulated in foreign countries will, in many cases, be completely unavailable to shareholders, and the earnings may be lost as a consequence of future operations. There is no justification for taxing the undistributed earnings to the shareholders prior to the time the income is realized through the payment of dividends.

Among the stated purposes for this proposal are the improvement of the balance of payments by discouraging foreign investment and forcing immediate realization of the foreign earnings. The proposal could have exactly the opposite effect on the U.S. economy. Exports will be impaired. The number of jobs available may be reduced, and total income tax revenues may be curtailed.

A manufacturing subsidiary located in a foreign country may actually result in increasing exports. Few of the machines produced abroad are manufactured directly from raw materials. Many of the component parts are produced in this country and shipped abroad for assembling.

Exporting component parts or materials to be further processed abroad benefits not only the company doing the exporting and having the controlled foreign corporation, but also suppliers of raw material who think of their business as being completely domestic.

SECTION 14—GAIN FROM DISPOSITIONS OF DEPRECIABLE PERSONAL PROPERTY

Recommendation: Section 14 should not be enacted in its present form. Capital gain treatment of gains from the sale of depreciable property should not be eliminated unless and until there is a corresponding liberalization of depreciation by statute. In no event should the elimination of capital gain treatment be made retroactive.

Explanation: It is recognized that problems exist in according capital gain treatment to the gain from the sale of depreciable property under section 1231 of the 1954 code. However, the categorical statement that gains from the sale of depreciable personal property are ordinary income in nature is not correct. Part of the gain is due solely to inflation—to the fact that the fraction of the useful life of a depreciable asset remaining at the time of sale may simply be worth more than the same fraction cost originally.

We oppose the enactment of section 14 because it is not coupled with a further liberalization of depreciation applicable to the property

to which section 14 would apply. We are also opposed to it because it would be retroactive in application. Thus, gain from the disposition of an asset would be taxed as ordinary income to the extent of depreciation taken with respect to that asset after the effective date of section 14, whether or not that depreciation was excessive, was exactly equal to the reduction in the value of the asset during that period, or was less than the reduction in that value.

To avoid discouraging new investments in plant, and the modernization of existing plant, any restriction upon the application of section 1231 should be limited to assets acquired in the future. Moreover, the restriction should only be applicable with respect to property over which management has a greater voice than now in determing the useful life to be used for depreciation purposes. In this way an investment in depreciable property can be recovered before inflation has taken its toll and gain resulting from the disposition will truly be ordinary income in nature.

In summary, our position with respect to section 14 is based upon the following:

1. Gain from the disposition of depreciable property which has been depreciated over long useful lives as required by the Internal Revenue Service consists, in part, of gain which is capital in nature. It is not all ordinary income.
2. The only equitable way to eliminate the section 1231 problem which does exist is by doing so prospectively so that present depreciation allowances and expansion and modernization plans will not be disturbed. The elimination should not be applicable to property in use at the present time.
3. The elimination of section 1231 without coupling the elimination with a further liberalization of depreciation will discourage expansion and modernization at a time when such expansion and modernization is most needed.

SECTION 17—TAX TREATMENT OF COOPERATIVES AND PATRONS

Recommendation: The provision of section 17 should be enacted to subject cooperative income to a single effective tax in the year earned.

Explanation: Section 17 would close a loophole in the revenue laws which has existed since the intention of Congress to tax the income of cooperatives by the passage of section 314 of the Revenue Act of 1951 was thwarted by judicial decisions holding that deduction of patronage dividends by the cooperative did not necessarily require their inclusion in gross income of the patrons, and that patronage paper allocations could be taxed to the patrons only to the extent of their fair market value.

Enactment of this section would guarantee the imposition of a single tax on all cooperative income, either at the cooperative or patron level. Corporations operating on a cooperative basis would continue to retain a substantial competitive advantage over business corporations whose income is subject to a double tax burden. Nevertheless, the legislation would eliminate the present situation where much of the income earned by cooperatives is immune from Federal taxation. This situation, which Congress previously attempted to correct and which was never intended to develop, unjustifiably compounds the competitive advantage of cooperatives.

SECTION 19—WITHHOLDING ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

Recommendation: Tax withholding should not be extended to dividend and interest income.

Explanation: It has been said that substantial amounts of dividend and interest income are now escaping taxation. The basis for that statement appears to be an assumption based upon a comparison of dividend and interest payments with reported income, taking into account additional assumptions concerning amounts which need not be reported. In view of the substantial increases in investments by nontaxable funds, it is reasonable to expect that an increasing portion of dividend and interest income is truly nontaxable.

An intense effort has been made in recent years by dividend and interest paying entities to inform recipients of the taxability of the income, and it is too early to typify those efforts as failures—if indeed there actually are substantial amounts of improperly unreported income. Results of the efforts which have been made should not be prejudged.

The detailed withholding proposals place substantial burdens on the paying agencies, persons holding securities as nominees, investment dealers, stockbrokers, and others performing vital functions in the securities market. Further, the proposals would add heavily to the work and expense of the governmental agencies. Taxpayers now conscientiously filing complete and proper returns would have added burdens, not only in return preparation but in securing refunds. Taxpayers entitled to refunds would, for a time at least, be deprived of funds which are properly theirs and should be available for their use. These additional burdens upon the Nation's economy would not be negligible and should not be imposed.

Even if some amount of dividend and interest income is improperly escaping taxation, the proposals would not assure correction of the problem. The proposals would accelerate cash collections by the Government, but the amount of net increase in true tax revenue is seriously questioned.

Detection of improperly unreported dividend and interest income will continue to be dependent upon enforcement procedures now in existence, or improved procedures which are expected from the proposed automation of tax return reviews.

In summary, we oppose tax withholding or dividend and interest income for the following reasons:

1. It is based upon an unproven assumption that there is substantial improperly unreported dividend and interest income.
2. It imposes an unjustified burden upon the economy.
3. It will not result in a substantial correction of the problem of unreported income, if the problem does exist.

SECTION 20—INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

Recommendation: Section 20 should not be enacted to extend the nature and amount of reporting required by both domestic corporations and individuals controlling foreign corporations. If the Treas-

ury Department believes present law is being avoided, it should propose amendments to cure the specific abuses alleged.

Explanation: Public Law 86-780 adopted in 1960 added section 6038 to the code and amended section 6046. The former section requires domestic corporations which controlled (more than 50 percent ownership) foreign corporations to file annual information returns for each controlled foreign corporation and subsidiaries of controlled foreign corporations. The Treasury Department has now proposed to increase this burden by extending the requirement to subsubsidiaries of the controlled foreign corporation. In addition, the Treasury Department would extend this burden to individuals. The present law puts an onerous burden on U.S. corporations operating in the international field. Any further extension of the already too extensive information requirements is unwarranted.

Section 6046 was designed to supply the Treasury Department with information about newly formed or reorganized foreign corporations. With this purpose in mind, information with regard to the creation, organization, or reorganization of foreign corporations was required of all U.S. citizens who were officers, directors, or shareholders of at least 5 percent of the outstanding stock within 60 days after the creation, organization, or reorganization of the foreign corporations. The Treasury Department now contends (without any apparent experience since the law is only a little over 1 year old) that—

> it is possible to avoid this information requirement where the U.S. citizen or resident becomes an officer, director, or owner of 5 percent or more of the value of stock of the corporation after the 60-day period.

The solution proposed by the Treasury Department would require any U.S. citizen who is an officer, director, or 5 percent shareholder on January 1, 1963, or who acquires such a position later, to file this information. The effect of this provision would mean that although information had been previously given to the Government, a new officer, director, or 5 percent shareholder would have to file the information return and to do so even if the company had not been organized or reorganized within the last 10 or 15 years, or even longer period. To require continued reporting of the same facts and information is repetitive and will not give the Government any useful information that it does not already have in its possession. To place this burden on taxpayers is unwarranted.

However, if the Government is convinced that the present law is being avoided, then it should limit its proposed amendment to cover only those situations. The old provision could be amended to provide that if there are no U.S. citizens who are officers, directors, or 5 percent shareholders within 60 days after a foreign corporation is created, organized, or reorganized, then the required information should be filed by the first U.S. citizen who does become an officer, director, or 5 percent shareholder any time thereafter. A provision such as this would plug the "loophole" that the Treasury Department apparently feels exists but, at the same time, would not require an endless stream of reports covering the same facts.

In addition to the comments covered in our prepared statement, I have a few notes I would like to have included in the record, pertaining to the recommendation made by the Secretary of the Treasury

yesterday for repeal of the $50 exclusion and the dividend received credit.

The Illinois State Chamber of Commerce has adopted a position in the past against the repeal of the $50 dividend exclusion and 4 percent credit. The sections of the Internal Revenue Code providing for special treatment of dividend income were enacted in 1954 after extensive study.

The purpose was to recognize, though to a limited extent, the inequity of subjecting income of corporations to two taxes, the corporate tax when the income is earned and the individual tax when distributed as a dividend.

The $50 exclusion and the 4 percent credit do not eliminate, but do somewhat alleviate, this double taxation of income, and they are sound in principle. Their repeal would be equivalent to a tax rate increase for all shareholders, which cannot be justified under the objectives stated for H.R. 10650.

In his statement to this committee yesterday, Secretary Dillon recommended repeal of the exclusion and credit by contending that in the past 8 years the proportion of total corporate public long-term financing accounted for by stock issues has not been proportionately higher, in relation to bonds, than it was in the 8 years prior to 1955. The statistical data upon which this contention is based are not susceptible of ready analysis.

However, it seems beyond question that, first, the $50 exclusion is an inducement to the small investor to acquire an equity interest in the Nation's business economy, and the impact of this inducement is reflected by the growing popularity of the monthly and other periodic investment plans successfully promoted by the members of the stock exchanges and, secondly, the 4 percent credit is a factor taken into account by every individual when considering whether to invest funds in corporate stocks, corporate bonds or tax-exempt bonds.

Further, the recommendation to extend double taxation of corporate income is contrary to the principle recognized in section 17 of H.R. 10650 which is approved by Treasury Secretary Dillon and by the Illinois State Chamber of Commerce.

This section is designed to insure that the earnings of cooperatives would be taxed currently either to the cooperative or to the patrons. There is no implication that any part of the income of a cooperative should be subjected to two taxes.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Hoffman. Any questions?

The next witness is Mr. William Flynn of the U.S. Junior Chamber of Commerce.

STATEMENT OF WILLIAM FLYNN, U.S. JUNIOR CHAMBER OF COMMERCE

Mr. FLYNN. Mr. Chairman and members of the committee, as vice president in charge of governmental affairs for the U.S. Junior Chamber of Commerce, it is a distinct pleasure to speak before this distinguished committee for the more than 200,000 young men of our organization. In our role of young leaders, we accept responsibility for clearly stating our position in regard to tax policy which is so critical

to the future economic progress and achievement of the individual, business and the Nation in all its diverse elements, at home and abroad.

In expressing our total objection to the tax proposals being considered, the Jaycees are motivated by a desire to reverse a tax philosophy and approach which has limited and is continuing to limit our country's economic potential. Our organization is intent upon securing an approach to taxation which minimizes to the greatest extent possible the harmful economic effects of taxation while providing the maximum potential for the Nation to fulfill the role of which it is capable, domestically and internationally. The pending tax bill fails completely in this respect and no amount of alteration within the existing philosophical framework can change this. What is wrong in principle cannot be corrected except through the adoption of a new principle.

For the last 30 years, this country has been wrestling with a tax straitjacket which is highly restrictive in relation to our competitive, free enterprise system. Claims are continually being made by some economic planners that Government intervention, direction, and control are the only means of assuring that the economy can achieve its real potential. But I ask you—have you ever seen a man perform at his best in a straitjacket?

Our recent record of inadequate growth which is of such great concern to the President, the Congress and the citizens of this country is due in large part to an earlier taxation policy formulated by tax policymakers who erroneously believed that our Nation had reached the point of being a mature, stagnant economy. The tax program before you is an example of refinement and sophistication of techniques but it is basically unchanged in underlying approach. Unfortunate but true is the fact that today we are completely lacking in a tax philosophy which is realistically based on the dynamics of growth.

Dr. Alvin Hansen, dean of the aforementioned mature economy theory, many of whose disciples are influential in tax and economic planning for the Government today, has within the last month had an article in the New York Times magazine which pays lipservice to the need for an energetic growth policy.

In reading this article, it is interesting to note that the facade has been altered but the brick and mortar are still set in the same old style. There is a continual effort to encourage the use of so-called stabilizers by government, although Dr. Hansen seriously questions the value of the investment credit, while proclaiming that adequate, long-range economic growth has been thwarted by lack of private investment which from 1955 to 1960 actually decreased from $74.7 billion to $72.7 billion based on 1960 prices. It is readily apparent that we cannot stabilize and control the private economy on one hand and then expect it to perform at optimum capacity on the other hand. Dr. Hansen's article confirms that the policies of the past have been inadequate but he resorts to the same devices in attempting to resolve the issue for the future. Such an approach falls of its own weight.

Some may say that a reversal of the existing approach is to go back in time but to these critics we reply that sound and sure progress is based on discarding that in the past which has proven to be deterimental and replacing it with an approach which assures to the greatest extent our future. Let us lift our sights on the future by resisting

what is wrong in principle and starting on the track toward a tax philosophy which offers the most promise in the long run.

Therefore, it is essential to document the fallacies of the proposed tax program in order that the two philosophies may be fully contrasted in approach and effect.

The investment tax credit would incur a revenue loss which would be offset by a number of revenue-raising measures. Because of this fact, it is assumed, and I believe correctly, that the underlying attempt of this legislation is to dilute opposition to the bill by including several self-interest provisions which are attractive to enough segments of the taxpaying public to overcome opposition to the other provisions which are decidedly detriment to the public and national well-being from the standpoint of governmental intervention, control, and manipulation. This raises the question then as to the basic motivation of those devising the plan. Are we producing a tax program designed to work to the advantage of the Nation and its people or are we attempting to buy support for a program on the self-interest motivation of the beneficiaries? It is readily apparent that all taxpayers, regardless of whether they gain or lose in the immediate future, are being utilized for the primary purposes of the Government in its continuing attempt to keep pace with the spending programs which are accelerating at a faster rate than the economy can provide for them through existing tax revenues.

Reflect if you will upon the evolution of the investment tax credit. It was advanced originally at a 15 percent rate with a direct tie-in to the taxpayers' level of depreciation. This was later changed to a flat rate credit of 8 percent.

Its latest form in the House of Representatives was at a maximum rate of 7 percent, scaled down according to lives of equipment, and limited to a maximum credit of $25,000 plus one quarter of the credit in excess of this amount. Despite all the modifications which have altered the credit to the point where the so-called advantages claimed for it can no longer have the effect which its proponents originally maintained, the investment credit still retains the basic principle intended—the authority for the Government to determine how funds in certain segments of the economy should be spent. It is this restriction and control which is identical to the tax policies of the 1930's and which actually was embodied in the unsuccessful undistributed profits tax.

However unattractive the element of control and manipulation may be, this approach has an even more significant meaning. By the establishment of such control, the Government has placed itself in the position of securing the revenues it needs, at the time it needs them. Although this year's direction is one of bestowing benefits on those who do the Government's bidding, the future may demand that a different approach, directly contrary to that presently advocated, best serves the Government's purposes. Such a situation is found in the tax bill before you in the modification of foreign tax provisions so as to impose severe limitations upon investment abroad. It seems to me that we have reached the point where we had better start looking at gift horses in the mouth.

Gentlemen, I ask that we be honest with ourselves and with the future of this country, in relation to the tax action contemplated.

Let us not be motivated on a basis of that which proclaims the virtues of free enterprise and the encouragement of capital formation on one hand while acting in a manner which goes directly opposite on the other. For those who believe that economic control by the Government is in the best interest of the public welfare and in keeping with our traditional economic beliefs, let them say so in order that the American public may be in a position to make a choice on the basis of the true alternatives. I realize that such forthrightness will never be achieved because once the distinction is apparent the choice is too easy to make.

Looking beyond the investment credit provision, the revenue-raising provisions are a combination of items which elicit support from some and opposition from others. Our reaction to these sections of the bill must be completely negative. The imposition of withholding on dividends and interest, the tightening of expense account provisions and the limitations on foreign investment are completely wrong in approach and effect. The provisions in regard to mutual and cooperative forms of business and legislative expense deductions must be opposed on the basis that they are completely incapable of doing what must and should be done in these areas.

The key revenue producer in the bill is the imposition of withholding of dividend income at a rate of 20 percent. Although we agree that any attempts to defraud the Government of taxes rightfully due requires appropriate enforcement measures to collect such revenue, we strenuously object to the Government withholding additional taxes on income which it must eventually return to the taxpayer. The withholding rate against wages and salaries presently results in overwithholding for approximately 40 million taxpayers presumably bulked in the lower taxable brackets, with temporary loss of income to these people. To establish another withholding system for dividends and interest in the face of these conditions, particularly when small amounts of such income are due from a large number of first income bracket taxpayers, is a most unjust and harsh form of taxation. There can be no condoning of tax action in which all taxpayers and payers of dividends and interest are being penalized because of the illegal acts of a minority of taxpayers.

Claims to the contrary notwithstanding, the withholding provisions impose a far greater and unnecessary burden upon the general public than would be the case if the Government utilized its existing enforcement procedures in conjunction with the automatic data processing system which will be in effect nationwide in 1966.

All taxpayers receiving interest and dividend income, but not eligible for exemption, will be required to make two additional entries and calculations on their tax returns. However, taxpayer determination of his status as to exemption, refund, and credit is even more difficult. There are three categories of both dividends and interest which are exceptions from any type of withholding. There are seven similar exempt categories confined to interest alone and five such categories exclusively for dividends. There are refund and credit procedures for individuals, State and local governments, tax-exempt institutions and corporations. Exemption certificates are available to two classes of individual taxpayers as well as to State and local governments and tax-exempt institutions. Under the proposal before you,

disbursing agents and taxpayers will be confronted with a mass of compliance requirements which are sure to leave even the technical experts shaking their heads.

The total situation is further complicated by the fact that disbursing agents will send only one check quarterly to the Government without identification of the recipient except as might be available through information returns presently filed with the Government. Neither would such payment reveal the amounts of such income applicable to each recipient. It is conceivable that anyone intent upon defrauding the Government will claim credit on their returns even though they have received no interest or dividend payments.

In light of the foregoing, it is extremely difficult, if not impossible to rationalize the installation of withholding in contrast to verification of information returns against tax returns through automatic data processing equipment. Under the latter procedure, the only people penalized are those actually failing to report income. A simple mail followup in most of these instances should produce the collection of delinquent taxes. The record would seem to indicate that the primary purpose of this measure is to support the revenue loss under the investment tax credit and nothing more.

On expense accounts, it is apparent that the Government is intent upon setting aside the rule of "ordinary and necessary" business expense. In this situation Government is requesting the authority to supersede business judgment with its own. This is confirmed by the administrative discretion which is granted to the Secretary of the Treasury in carrying out the provisions of this section. Contrary to all accepted principles, the Government wishes to be the silent partner of business in determining what constitutes doing business and what good will expenditures are directly beneficial to the taxpayer's business. Although a step in this direction would be a serious blow to the freedom of business management in one area, an even greater danger lines in the fact that once a precedent is established for entertainment and expense account allowances it opens the door to similar intervention into all types of business expenses regardless of business need, purpose, or intent. This provision would be a major step in the direct governmental control of business operations.

In the foreign tax area, we are faced with a direct contradiction in terms of Government policy and objectives. In H R. 10650. the intent is to eliminate or limit existing tax provisions which have longstanding acceptance, benefit, and precedence in order to curtail foreign investments. In the proposed trade bill, the course of the Government is to encourage trade by Americans abroad. In the internationally competitive markets of today it is absolutely essential that we provide the maximum opportunity for Americans to compete. Any and all effeorts which are contradictory to such an objective can only be a step in the wrong direction.

It is readily apparent that we are at a crossroad in relation to the future direction of tax policy. The choice is clear. We can persist in adhering to the outmoded techniques and approaches of the past with future intrusion of Government into the workings of the private sector of the economy and pay the tax dollars necessary to achieve a Government directed economy which offers only more and more government spending and programing as the only solution to the problem.

The record of history speaks clearly enough on this point to make us at least stop and pause before continuing down such a path. There is another path which offers real promise for economic growth on a sound basis over the long run. This approach requires no shifting of tax burdens and no complex gimmicks to make the economy respond to the tune of the piper. It calls for a comprehensive reform of tax rates and methods in order that the barriers to capital accumulation and usage may be lowered so that the economy, freed of existing restraints, may move to higher levels with resulting prosperity and opportunity under our system of free enterprise.

The U.S. Junior Chamber of Commerce since 1959 has been supporting the need for such reform of tax rates and methods. It is our firm belief as young men that the greatest opportunity for our success and future rests in a tax system which fully develops the advantages found only under our free enterprise system. The enhancement of our way of life is dependent to a large part on a tax structure which does not inhibit capital and thereby reduce opportunities. On the contrary, the release of capital through reduction in individual, corporate, and gift and estate tax rates and alteration of capital gains treatment and depreciation methods provides a real chance for young men on their way up to realize the great American dream—to aspire to the maximum point of individual accomplishment. Although we are bound by the events of history in terms of our present status, we are not content to accept this as our fate. We want to enhance our individual opportunities at the same time that we work for the progress of our country. We do this by supporting the only legislation and philosophy which hold genuine promise for the well-being of all segments of the economy.

We believe that free enterprise is more than good words. Jaycees express this belief in their creed which states that, "Economic justice can best be won by freemen through free enterprise." Further, we are convinced that capital growth is an indispensable element of free, dynamic, and progressive economy. It is only when we tear down the impediments to capital formation that the economy is in a position to take its head and show what it can really do. Capital, contrary to some erroneously held beliefs, is never in sufficient quantity to meet all the uses to which it could be put if available in unlimited quantity. The United States, though it has been richly blessed, has never experienced the situation of having enough or too much capital because there is no such thing.

Capital is always in demand and except for insignificant amounts it is always in use. When more capital is avaliable it too will be used. The limitless uses to which capital can be put makes it impossible to state precisely in what manner capital will be used but there is no question but that it will be put to some purpose as soon as it becomes available.

Our difficulty in recent years has been due to the fact that we have failed to learn and accept this very basic economic truth. We have incurred no difficulty in recognizing and helping nations abroad to increased levels of economic growth through making capital available to them but we have been unwilling to recognize that exactly the same need exists here. Many nations of Western Europe today are prize examples of vibrant, growing economies due to the American capital

which has been fed into these countries through both private and governmental sources. It seems that we would be far better off to recognize this fundamental fact in preference to accepting the principle of the investment tax credit which has been so prominent in some of the slower growing, semisocialistic nations in that part of the world.

Gentlemen, we can avoid an issue for just so long and then escape becomes impossible. I am convinced that we stand on such a threshold at this time. What we place before you is not a plea for a Democratic or Republican solution to a most urgent and pressing need. It is an approach which this Nation must have for the enhancement and development of its fullest resources in an economic sense. If those who plead for greater economic growth are sincere and dedicated to the achievement of this objective then let us not waste valuable time in deliberating on half measures or on solutions which recent history confirms as totally unsuitable.

We live in an age of momentous decisions which determine whether our country and its way of life shall survive and prosper or whether State control and human enslavement shall succeed. I am sure that none of us would think twice about defending our country from its enemies—perhaps we have been overly generous in not fully questioning the huge expenditures made annually for military defense, yet we make this decision on the basis of necessity for survival. I ask you, Is our economic defense as adequate and as well supported? Certainly the President does not think so and I am sure that you would agreee. But we cannot continually resort to politically expedient methods in the hope that perhaps this will be successful. Time is running out and we cannot just hope that our actions will prove to be successful.

I am 100-percent convinced, as are Jaycees throughout this country, that we need a big answer, a far-reaching solution, and courageous action to overcome the deficiencies which have been built up under our existing tax system. Yet the solution for comprehensive reform of tax rates and methods, now in legislative form before the Senate in S. 2932, and in the House as the Herlong-Baker bills, is moderate in its approach and provides for gradual reduction of tax rates annually over a period of 5 years. Should a major financial crisis threaten budget balance, the President and the Congress would have full power to postpone any scheduled reduction for 1 year.

The provision for gradual rate reduction over a 5-year period would put the choice squarely up to the Congress—do you favor tax rate reform which would benefit the private sector of the economy in terms of economic growth and greater opportunity for the creation of new risk ventures and expansion of existing businesses which in turn provide new and better job opportunities, a higher standard of living, improved capacity to meet our domestic and foreign commitments and competition, or do you prefer increased Government spending and with it the continuation of an inadequate growth rate and increased competition for a larger portion of a less rapidly expanding revenue fund? There is no question as to what the answer is.

Nevertheless, the Government will not suffer as a result of this action for in the long run the revenues available to Government will expand with the economy so that the Government will be in a better position to fulfill its necessary obligations than under an insufficient growth rate.

Gentlemen, the economy can be incited to maintain its present level or perhaps an even slightly better record through the use of props and temporary stimulants, but the result can never cure all the attendant problems stemming from insufficient growth. However, noninflationary, long-term growth with readily attainable growth levels of 5 percent or even higher is not only possible but easily within reach once the decision is made to release the restrictions on the economy through the expansion and creation of new capital.

The potential of our free enterprise economy can be unleashed by breaking with the past and making the one choice which will assure the most promising of futures for Americans and reaffirm throughout the world that freemen under our economic system can achieve a level of progress and achievement unmatched by any other system.

Thank you very much, gentlemen.

The CHAIRMAN. Mr. Flynn, I want to congratulate you on a very excellent statement.

Mr. FLYNN. Thank you, Mr. Chairman.

Senator CARLSON. Mr. Chairman, I certainly want to commend Mr. Flynn for his excellent statement. I think the representatives of the members of the junior chambers of commerce in this Nation can well be proud of the presentation you have made here today. It is an excellent statement on the preservation of our private enterprise system, and being personally acquainted with the president of the Junior Chamber of Commerce of Salina, Kans., James Wymore—you may have met him, you may know him——

Mr. FLYNN. Yes, sir.

Senator CARLSON. I know that you are speaking his views, and I want you to know that personally I appreciate it very much.

Mr. FLYNN. You are very kind, Senator.

The CHAIRMAN. Thank you, Mr. Flynn.

The committee will adjourn until 10 o'clock tomorrow morning.

(Thereupon, at 4:40 p.m., the committee recessed, to reconvene tomorrow, Wednesday, April 4, 1962, at 10 a.m.)

REVENUE ACT OF 1962

WEDNESDAY, APRIL 4, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (the chairman) presiding.

Present: Senators Byrd (chairman), Kerr, Smathers, Douglas, Gore, Williams, Carlson, Bennett, Curtis, and Morton.

Also present: Elizabeth B. Springer, committee clerk; and Colin F. Stam and L. M. Woodworth, of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order. The first witness this morning is Mr. Stanley Ruttenberg of the AFL-CIO, accompanied by Andrew J. Biemiller.

Take a seat, gentlemen.

Proceed, sir.

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY ANDREW J. BIEMILLER

Mr. RUTTENBERG. Thank you very much, Mr. Chairman.

I have a longer prepared statement that runs to about 40 pages which I should like to have inserted into the record.

The CHAIRMAN. Without objection it will be inserted at the end of your testimony.

Mr. RUTTENBERG. And might I then spend my time orally summarizing the document?

The CHAIRMAN. You may proceed, sir.

Mr. RUTTENBERG. We think the effort of the Ways and Means Committee to put together this bill was a good step forward in terms of basic tax reform. We commend the committee and the Congress for considering tax reform at this point, and taking a first step toward basic changes in our tax law.

This statement of ours today deals with certain improvements that we would like to see made in H.R. 10650 as it has been passed by the House.

My statement deals with eight different issues: investment credit, dividend and interest withholding, repeal of the dividend credit and exclusion, ending capital gains treatment for depreciable assets in real as well as personal property, the tightening of expense account allowances, the removal of the provision in H.R. 10650 dealing with lobby-

ing expenses, a discussion of thrift institutions, and lastly but not least the problem of taxing foreign income.

I should like in the course of my oral presentation, Mr. Chairman, to deal in the main with three of these eight subjects, and then, if time permits, to refer very briefly to the others.

The first issue I would like to deal with is the question of the investment credit.

We think this is certainly a new and different and novel proposal. But we do not think that it will do the job that it is designed to do. We do not think that it will accomplish its purpose of making our productive machinery more efficient. Nor will it reduce our balance-of-payments deficit or increase our export trade, and it will not promote the economic growth and expansion that it is designed to do.

We cannot and we do not support the investment credit. It is justified by its supporters on the ground that, one, it will improve our world competitive position. We deal in my statement with this problem. Suffice it to say that I can't see how our world competitive position can be improved as a result of this bill. In the year 1961 our export surplus was already $5½ billion as compared with an export surplus over imports in 1959 of only $1 billion.

As a matter of fact, more than $5 billion of the $5½ billion surplus is due exclusively to a surplus in manufacturing export items over manufactured import items. If we were not competitive, it seems to me we would not be able to maintain this kind of an export surplus.

So much for that.

The second point which is advanced as an argument in support of investment credit is that it would increase the cash flow to corporations and thereby supplement funds that corporations need to promote financial investment.

We do not think that any of the facts justify the view that there is a shortage of investment funds on the part of American corporations today.

In the post-World War II period from 1946 through 1961 American corporations, excluding financial institutions, invested $374 billion in new plant and equipment. And over this period of time an amount equal to 96 percent of that total investment was supplied by two sources, depletion allowances and retained earnings after distribution of dividends. And in the year 1961 these sources of corporation funds exceeded plant and equipment expenditures by 6 percent. These figures are very clearly dealth with in the Council of Economic Advisers report in a table dealing with sources of funds for expenditure by corporations.

It is interesting to note that in 1953, prior to the Revenue Act of 1954 which liberalized the depreciation procedures in our tax laws by moving from straight line accounting to double declining balance and sum of the digits, total depreciation set-asides equaled 49 percent of the funds used for plant and equipment; by 1961 depreciation set-asides equaled 80 percent of equipment and plant expenditures.

So we don't think there is a basis for saying there is a shortage of investable funds for corporations; certainly, if one looks across the board at our 500 major corporations, companies like General Motors, General Electric, Westinghouse, Ford, all have had sources of funds in the last 3, 4, or 5 years that considerably exceed the total amount of money which they have invested in new plant and equipment.

So from that point of view we see no justification for the investment credit.

Thirdly, it is argued that it will stimulate private capital investment that wouldn't occur otherwise.

It is argued that our equipment is older and, therefore, ipso facto, not as modern or as efficient as that of other countries. We challenge those who say that our equipment is not as efficient and modern as that found in other countries around the world and we challenge the statistics which try to show that the average age of our equipment is, therefore, much older and, therefore, consequently, they say less efficient in other countries around the world.

There is another argument which is being made currently. As a matter of fact, the Secretary of the Treasury made the argument in his presentation here the other day. He said that if you compare depreciation rates in the United States with rates of other countries around the world, you find that the representative tax life of equipment in the United States has averaged 19 years as compared with an average of anywhere from 5 years in Sweden to 10 years in most of the other European countries to 16 years in Japan, and 27 years in Great Britain.

Therefore, the argument is made if we want to compete with these companies overseas it is essential for us, in our approach to tax laws through investment credit or depreciation changes, to change our law so that Americans too can write off equipment faster.

I have a table and a memorandum which deals with this subject. I wish I had time to go into it but suffice it to say that the general conclusion is that if you look at these average lives of depreciable assets in countries abroad and in the United States and then compare these rates with the rise in industrial production, there is no correlation whatsoever.

Some of the countries of Europe who write off 90 or 95 percent of their equipment in the first 5 years have had lower increases in industrial production and gross national product than some of the other countries that write off equipment, not in the first 5 years at 90 percent but write it off at 60 or 65 percent.

I have such a table here, Mr. Chairman, which I would be glad to insert in the record if you would like.

The CHAIRMAN. Without objection it will be inserted in the record.

(The information is as follows:)

The attached table points up one serious fallacy in using international comparisons to prove that the United States needs to adopt the investment credit and faster depreciation incentives: There is no correlation between faster tax writeoffs or liberal incentive allowances and changes in economic growth rates or industrial production improvements.

All but the last two columns in the table have been used by Secretary of the Treasury Dillon (see table 1, p. 9, of his testimony on April 2 before the Senate Finance Committee) to demonstrate that U.S. depreciation and other allowances are not so rapid or so liberal as those in other industrial countries. The last two columns, however, point up some of the inconsistencies of using this type of data to prove that America must try to emulate foreign tax systems in order to accomplish faster growth or needed rises in industrial production.

For example, Sweden is the country with the fastest tax writeoffs and possibly "life span" for equipment, according to the table. Equipment may be written off 100 percent in 5 years in Sweden. The "representative tax life" of Swedish equipment, according to the Secretary's table, is 5 years. But the rise of Swedish gross national product between 1953 and 1960 was among the lower of

the countries shown on the table, 30 percent in the period; its industrial production increased 35 percent.

But Japan, a country whose tax writeoff is considerably less than Sweden's—only 68.2 percent in the first 5 years, for equipment with a representative tax life among the longest, 16 years—had the most rapid growth both in gross national product and in industrial production—77 percent and 168 percent, respectively, between the years 1953 and 1960.

Again, Belgium, with 92.5 percent writeoff in the first 5 years, has equipment with the short lifespan of only 8 years. But even the United Kingdom, with a representative equipment life of 27 years and only a 64 percent writeoff in the first 5, shows a faster growth rate than Belgium, both in terms of gross national product and in terms of industrial production.

Or, if there is a correlation, why should France, whose equipment is written off 76.3 percent in the first 5 years have a slower growth rate than West Germany, whose equipment is written off 67.2 percent in that period? Yet the table clearly shows France well behind West Germany, in both growth and industrial production rises between 153–60.

The table does show that U.S. depreciation allowances and typical lifespans of equipment as well as growth and industrial production rises have been less rapid than other countries. It also shows, however, that changing the U.S. tax provisions would not mean that the U.S. industrial production or gross national product increases would improve.

It is not only wrong to consider these items in a vacuum, as this table does. It is also wrong to draw from the table's data policy conclusions which the data itself does not support.

Comparison of depreciation deductions, initial and incentive allowances[1] for industrial equipment in leading industrial countries with similar deductions and allowances in the United States

	Representative tax lives (years)	Depreciation deductions, initial and investment allowances (percentage of cost of asset)			Rise in gross national product, 1953–60 (percent)	Rise in industrial production, 1953–60 (percent)
		1st year	1st 2 years	1st 5 years		
Belgium	8	22.5	45.0	92.5	21	27
Canada	10	30.0	44.0	71.4	22	30
France	10	25.0	43.0	76.3	36	68
West Germany	10	20.0	36.0	67.2	61	80
Italy	10	25.0	50.0	100.0	49	82
Japan	16	43.4	51.0	68.2	77	168
Netherlands	10	26.2	49.6	85.6	42	57
Sweden	5	30.0	51.0	100.0	30	35
United Kingdom	27	39.0	46.3	64.0	22	30
United States	10	10.5	19.9	42.7	19	19

[1] The deductions and allowances for each of the foreign countries have been computed on the basis that the investment qualifies fully for any special allowances or deductions permitted. The deductions in the United States have been determined under the double declining balance depreciation method, without regard to the limited 1st-year allowances for small business.

Source: Statement by Douglas Dillon before Senate Finance Committee, Apr. 2, 1962, table 1, p. 9; and Organization for European Economic Cooperation, "General Statistics," July 1961, No. 4.

Mr. RUTTENBERG. There are other arguments certainly——

The CHAIRMAN. Mr. Ruttenberg, before you say that, I want to say to you you have made one of the best arguments I have heard in opposition to the investment credit and I am very glad that on this matter we are in complete agreement. [Laughter.]

Mr. RUTTENBERG. Thank you very much, Mr. Chairman. I am glad we are in agreement on this issue.

We certainly——

Senator GORE. Mr. Chairman, that is about as unusual as for me to be in company with the U.S. Chamber of Commerce. [Laughter.]

Mr. RUTTENBERG. I hope, Mr. Chairman, we are in opposition for the same reasons, and I think we are, as we look at these facts.

I agree with you fully when you made the statement the other day you can't quite see how you can retroactively accelerate investment in American industry. I thought that was a very excellent and short and quick summary of the issues involved in this case.

We would urge you to delete this provision from the bill, because we think it is a multibillion-dollar windfall that will not really contribute anything to our national goals and will not relieve our balance-of-payments problem as it is claimed to be.

Senator GORE. May I point out one thing there, Mr. Chairman?

The CHAIRMAN. Senator Gore.

Senator GORE. Though it is advocated on the basis of meeting a current situation, it is recommended as permanent legislation.

Mr. RUTTENBERG. That is so right, Senator Gore.

I would like, in this connection, to make a couple of suggestions. I would hope that the committee would delete this provision from the bill.

But if it feels it needs something in this connection I would like to throw out a couple of suggestions, not that I think they ought to be a substitute for what is there because I think what is in the bill ought to be deleted. If you really believe, however, you need to help our foreign competitive trade situation, rather than having an investment credit which goes across the board—it helps barber shops, it helps agriculture, it helps bowling alleys, it helps equipment in shopping centers, thank goodness it doesn't apply to plant but only to equipment as it is written in the bill, that is a help; it applies also to utilities which obviously don't need the help—why don't we direct the investment credit to just those industries involved in international trade, export industries and others that have serious import disadvantages. In this way we could apply the use of this mechanism selectively for a limited period of time, as long as we have a balance-of-payments crisis.

Senator GORE. Could I make one addition?

I feel myself in sympathy with much of what you have suggested if you would add to it that the credit only apply to that degree of plant improvement which is over and above the normal experience of the industry.

Mr. RUTTENBERG. I would wholeheartedly agree with that. Of course, it was President Kennedy's original recommendation that the credit would apply only to that level of investments which exceeds past depreciation allowances, and I think that is a very excellent idea and certainly I would join with you, Senator Gore, in urging at least that it be restricted to that area, if it is accepted at all.

I would like, Mr. Chairman, to pass now from that issue to the second one which I deal with in my statement beginning an page 30; namely, the area of foreign income.

Our general position is that taxes should be neutral in investment decisions of American corporations. As it is now, with the general provision that income earned overseas is deferred until repatriated, this becomes a factor in the decision of a corporation as to where it will invest its money and when.

If we did not have such tax deferral, if we removed it completely from income earned overseas, the decisions would then be made legitimately in line with the normal reasons for capital to flow from this country to other countries.

The tax angle or tax factor would not be a consideration. And, therefore, we would urge you, Mr. Chairman, in terms of the committee bill, as we do in our statement, to improve it to the extent of making all income earned overseas subject to immediate U.S. tax with, of course, an allowance for the foreign tax paid.

This is the provision which is in the bill as it relates to income from patents that flows to foreign subsidiaries of American companies, but there are these loopholes, there are these provisions, for example, in the bill as it now stands that in the so-called tax-haven operation income derived in a tax haven like Switzerland or the Bahamas or the Caribbean area, that such income shall also be deferred from tax if it is invested in less-developed countries. Then, of course, there is also a provision in the proposed bill relating to the manufacturing-type corporation which sells directly, say, from its manufacturing subsidiary in Germany, that tax deferment applies, if it is reinvested in less-developed countries or if it is invested in itself.

We would suggest that these provisions be removed and that the income be subject to tax when earned and that tax deferral for income earned overseas be continued only for income which is generated in less-developed areas.

So that income earned from a manufacturing subsidiary, let us say, in Germany would be subject to U.S. tax, the income would come back to the United States, I think thereby improve our balance-of-payments position by returning more dollars to the United States than flows out. If, in turn, that corporation wants to invest that income in a less-developed country it could invest it and enjoy tax deferral thereafter for income generated in the less-developed area.

Senator DOUGLAS. Mr. Chairman, may I request a question?

The CHAIRMAN. Yes.

Senator DOUGLAS. We do this to avoid the possibility, I take it, that firms would locate subsidiaries in a less-developed country which were built on the profits made in the developed countries; is that it?

Mr. RUTTENBERG. Yes, that is right, Senator Douglas. Because if there is a legitimate reason for the income to be invested in the less-developed countries, let that reason be the generation of income in that area, not the generation of income in Germany or developed areas.

Senator DOUGLAS. In other words, this danger is guarded against, that Liberia might take the place of Lichtenstein?

Mr. RUTTENBERG. Right.

I think that is perfectly right. I think the principle should hold and we——

Senator GORE. Mr. Chairman, may I ask a question?

The CHAIRMAN. Senator Gore.

Senator GORE. I asked the Secretary of the Treasury the other day, if, in his opinion, Congress would be but piddling with the question of preferential treatment of income earned abroad unless it attacked forthrightly the deferral of tax liability, and his answer was "Yes."

Do you agree with that?

Mr. RUTTENBERG. Yes, I agree with that.

Senator GORE. Senator Douglas has just illustrated the fallacy of the piecemeal approach contained in the present bill.

Unless we apply tax liability annually on profits earned abroad, the preferential treatment of profits earned abroad remains.

If we put our finger in one hole in the dike, three more may break out, either through the like or under it. What we need to do is to take down the dike, which is the deferral privilege.

Mr. RUTTENBERG. Perfectly right, Senator Gore, and I would add one word to that. If you put your finger in the dike the way the House bill does, all we are doing is in effect giving a tax-free loan, an interest-free loan to the corporation that decides to reinvest in the less-developed area.

Senator GORE. Well, that might be the least that we are doing. We might be giving them complete tax exemption forever.

Mr. RUTTENBERG. Yes, because the income would never be repatriated. Yes, that is true. There is one other provision which we, of course, touch in our testimony that I would just like to mention in passing. We would hope that if you accepted the notion of giving tax deferral only for income generated in less-developed areas that you would include a provision which would say that tax deferral would not apply to that part of income earned in a less-developed country that is derived from the sale of products in the American market.

If we invest money in India, so long as the income from that investment is from the sale of products in India or in other countries of Asia, Africa or other parts of the world, fine.

But if there is a certain proportion of that income earned from the sale of products back on the American market, then the tax deferral should not apply to that portion of the income which is earned on the American market.

Senator BENNETT. May I ask a question, Mr. Chairman?

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Suppose you had the firm manufacturing in India and selling in Germany, would you deny deferral for profits earned by production in an underdeveloped country and based on sales outside the United States but in a developed country?

Mr. RUTTENBERG. No, I would not.

The only exemption to tax deferral for income generated in less developed areas I am suggesting is if it is from the sale of products back on the American, not German, market because if we gave them tax deferral on products in Germany we would open up the same loophole by suggesting the closing of tax deferral derived from sales of the tax haven.

Senator BENNETT. Maybe I am misunderstanding.

It isn't the tax deferral you give them if they sell in Germany, it is a denial of the tax deferral you give them because they are manufacturing in India. You are going to deny them the deferral if they sell in the United States; are you going to deny them the deferral if they sell in Germany?

Mr. RUTTENBERG. If it is from a corporation, manufacturing corporation, in India, that is what we are talking about now as a less developed country.

Senator BENNETT. That is right.

Mr. RUTTENBERG. Yes. Yes we would give them the tax deferral on the income earned in India if it is generated as a result of sales in Germany, but not if it is generated as the result of sales from the United States.

Senator BENNETT. I wanted to get that clearly in my own mind.

Are you talking about manufacturing companies only or companies that develop raw materials that are located in a less-developed country?

Mr. RUTTENBERG. I am talking about all types of manufacturing, mining, or production operations; yes.

Senator BENNETT. Well, then, let me put this question to you: An American oil company, let's say, develops an oilfield in India, manufactures its commercial products there, but sells them exclusively on the European market.

They would have the benefit of the tax deferral because the oil came out of India?

Mr. RUTTENBERG. They would except that under present laws, and present methods of operation the petroleum companies normally operate through a domestic branch and consequently do not now take tax deferral on income earned overseas; they do this for the peculiarly interesting reason that if they took tax deferral they would not be eligible for depletion allowances, but if they give up their tax deferral and operate overseas as if they were operating in the United States, the oil and petroleum companies then take their depletion allowances and they find this is a greater advantage. So what we are talking about, Senator Bennett, does not really apply to the petroleum companies because of the peculiar way in which they now currently, and I assume will continue to in the future, operate overseas.

Senator BENNETT. Thank you.

Mr. RUTTENBERG. There are a few other aspects of the foreign income provisions affecting individuals which I would like to just briefly refer to, if I might, Mr. Chairman.

We agree with the suggestion of the Secretary of the Treasury made here the other day that the first $20,000 of income earned by an individual who resides in a less-developed country, either on a permanent basis or 17 out of 18 months should be exempt.

The bill as it now stands provides for continuing the $20,000 exemption for those individuals residing 17 out of 18 months regardless of the area of the world in which they reside. Then it extends it to $35,000 if they reside overseas for 3 years or more.

We do not think these provisions are equitable. We think that an individual who works in Rome as a movie star, or an individual who works in Hollywood as a movie star should pay the same income as long as they are American citizens.

We would suggest the first $20,000 of income earned overseas in less-developed areas be exempt from taxation if the individuals stay there for 17 out of 18 months or establish foreign residence but that would be the only exemption that we would suggest making in the individual area.

Senator BENNETT. Mr. Chairman, may I take the witness back again into this tax deferral business?

It's been called to my attention that the President recommends that Puerto Rico be considered as an underdeveloped country. This presents an interesting problem.

If American domestic mainland corporations can go to Puerto Rico, get the benefit of tax deferral that is considered to be an underdeveloped country, do you think it should be so considered in this context?

Mr. RUTTENBERG. I would think, Senator Bennett, the thing which one ought to keep in mind about Puerto Rico as underdeveloped as it is, is that the citizens of Puerto Rico are citizens of the United States as contrasted to the Bahamas or the Caribbean countries where there are tax havens and where we ought not to continue tax deferral they are not citizens of the United States.

I think we have to look at Puerto Rico in a slightly different way than we would look at Liechtenstein or the Bahamas or other Caribbean countries, Bermuda.

Senator BENNETT. Well, the people of Puerto Rico already have a tax haven so far as personal income taxes, American income taxes, are concerned and many corporations go down there because they get tax advantage.

They escape the American corporate tax rate and the Puerto Rican Government gives them certain privileges.

Now, on top of that, if they can go down there and can use that as a manufacturing base and sell their material in South America with complete American tax deferral, this is just an interesting aspect of this attempt to set spots in the world where we give taxpayers certain privileges that we deny in other spots in the world.

Mr. RUTTENBERG. Except, Senator Bennett, of course, that the Puerto Rican Government has made it quite clear they will not grant tax privileges nor do they want corporations to come to Puerto Rico who are running away from operations in the United States.

This is very clear cut—it isn't part of the law, there are clear-cut rules and regulations which govern the applicability of the special tax provisions that exist in Puerto Rico as they relate to corporations.

So that I think that is the important consideration to keep in mind when we look at the problem of Puerto Rico.

Senator BENNETT. But there are many American corporations that find their way down there and do escape the taxation.

In other words, the Government of Puerto Rico has the power to decide whether in their opinion these people are running away or whether they are desirable sources of jobs in Puerto Rico.

Mr. RUTTENBERG. Yes, but the important consideration to keep in mind is that the plants that move to Puerto Rico are in the main, if the Puerto Rican Government holds to its rules and regulations which it tries very hard to do, corporations which are increasing their total level of operations throughout their entire structure in the United States including Puerto Rico.

If they close their operations in New England, close their plants and move to Puerto Rico, it tends to deny them the privileges.

They refuse to give them, and deny them a runaway situation, although there are times when it is difficult to decide when it is runaway or not.

Senator BENNETT. Do I understand your statement to be if it goes into Puerto Rico it is an underdeveloped country by definition and if it makes the product it ships back into the United States it would lose its deferral because it is an underdeveloped country.

Mr. RUTTENBERG. As I said, Puerto Rico ought to be looked upon differently than an underdeveloped country. If what you say, instead of taking Puerto Rico as the example you took——

Senator GORE. Mexico?

Mr. RUTTENBERG. Mexico, India, or Indonesia.

Senator BENNETT. I am taking Puerto Rico because it is a special case.

Are we going to have to write special legislation in this bill for Puerto Rico or aren't we giving Puerto Rico an additional attraction for American business?

"Come to Puerto Rico, manufacture your stuff, it is only a little way off the coast, you can defer your tax indefinitely on products that you sell in South America."

Mr. RUTTENBERG. Of course, as far as some of the States in the United States are concerned they give tax advantages to companies that move into their areas, so we have this internally within our 50 States.

I think when we get into Puerto Rico we have a special kind of problem that I think needs to be looked at specially and separately and distinctly from the whole concept of less-developed countries where citizens are not citizens of the United States. I think this is the key problem, Senator, as I see it.

Senator BENNETT. Yes.

Mr. RUTTENBERG. If I might just briefly state that some of the provisions in the foreign income section such as the gross-up provision for foreign taxes, the elimination of exclusion of real property from estate tax base, and the development of a formula for allocating profits for the sales company located off the U.S. shores for purposes of selling American manufactured products are all good provisions and we certainly would urge that they be retained in H.R. 10650 in the foreign income section as they are.

Senator GORE. Mr. Chairman, if I may ask a question.

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Ruttenberg, the recommendation you have made, that the first $20,000 of personal income of American citizens residing in underdeveloped countries be exempt from U.S. taxation, might well move the American movie colony from Geneva and Rome to Mexico City.

Why would it be any more justifiable—well, I won't call the names of any of our stars—for any of them to have a $20,000 exemption from taxation in Mexico City than in Geneva.

Why are you prejudiced against Switzerland?

Mr. RUTTENBERG. Well, I am prejudiced not against Switzerland because I think that is a lovely country. I am prejudiced against all the movie stars, of course, that are making movies in Italy and in Great Britain and in France and other countries of the continent of Europe.

I think the issue, the justification for the $20,000 exemption as it relates to less developed countries is——

Senator GORE. There is no justification; let's talk of it in terms of excuses.

Mr. RUTTENBERG. Well, the excuse for it would be, if you want to use that term, I think there is in part a slight justification.

Senator GORE. What is your excuse for it?

Mr. RUTTENBERG. Well, my excuse for it would be, my justification for it would be——

[Laughter.]

Mr. RUTTENBERG. My excuse and/or justification——

[Laughter.]

Senator GORE. We are coming close to understanding.

Mr. RUTTENBERG. What was that book years ago done by Stuart Chase called "The Meaning of American Language," but words have different meanings.

Now, my reason for looking at it would be we do need to encourage American individuals to take jobs in many of the developing countries of the world that are really hardship areas.

Senator GORE. All right.

Let's not talk about the movie star. Let's talk about the American workman, a member of the AFL-CIO, working in San Antonio or Los Angeles, who has an exemption of what?

Mr. RUTTENBERG. Now, of course, he gets his $600 exemption for himself plus each of his dependents, plus a minimum of 10 percent of his gross income.

Senator GORE. But if he works in Tia Juana or Monterey, under your recommendation how much would you give him?

Mr. RUTTENBERG. Of course, he would have to work in Tia Juana and Monterey for 17 out of 18 months or become a permanent foreign resident of Tia Juana and Juarez or any of the other areas.

Senator GORE. Well, this permanent residency is partly a fiction.

I don't care to discuss this for too long. But suppose he met the requirements of your recommendation. You would give a member of your organization working in San Antonio an exemption of $600 for each of his dependents, and for himself, but if he worked across the line and had a so-called residence across the line you would give him an exemption of $20,000.

Mr. RUTTENBERG. This would be the consistency of the position which I have taken and which we have taken in terms of the exemption for less-developed areas.

Senator GORE. Are you very proud of the consistency?

Mr. RUTTENBERG. I think in using Tia Juana and Juarez and border towns of Mexico and Texas makes the problem look ridiculous in its extreme, I will grant you that.

Senator GORE. Let's place it in Toronto then.

Mr. RUTTENBERG. Well, Toronto, of course, it wouldn't apply because Canada would not be a less-developed area.

But I guess you could say that it would apply to Chile, Brazil, Argentina.

Senator GORE. Bahamas.

Mr. RUTTENBERG. Colombia.

Senator GORE. The Bahamas, it is a 30-minute flight from Miami, you know.

Mr. RUTTENBERG. Bahamas and Bermuda, I grant you that there——

Senator GORE. Are you getting prouder of your consistency or less proud? [Laughter.]

Mr. RUTTENBERG. I must say, Senator Gore, you give me pause for thought.

Senator GORE. All right, let me give you another pause.

If you are going to give it to a movie star who is making a movie in Mexico City, what about the U.S. Ambassador to Mexico?

Mr. RUTTENBERG. Well, he would be, I guess, entitled to it if he stayed there in a tour of duty for more than 18 months.

Senator GORE. No; he is not.

Mr. RUTTENBERG. Not as a Government employee?

Senator GORE. Of course not.

Do you recommend we give it to him?

Mr. RUTTENBERG. Senator Gore, I think, I don't want to—I guess I do want to beg the question. [Laughter.]

I want to, though, put what we are talking in the proper context.

Senator GORE. I am trying to do that, too.

Mr. RUTTENBERG. Well, mind you——

Senator GORE. Just go right ahead at it.

Mr. RUTTENBERG. The suggestion which is now in the bill, which is now in H.R. 10650, is a provision which says that $20,000 exemption for any individual establishing foreign residence or living for 17 out of 18 months anywhere in the world, shall be entitled to exemption and if he resides abroad for more than 3 years he shall be entitled to a $35,000 exemption.

That is the current provision in the bill.

I would hope that at least it would be closed, narrowed down to this very little area that you and I are now talking about as it relates to that exemption.

Senator GORE. It is not a little area.

Mr. RUTTENBERG. If you want to remove it from the less developed areas.

Senator GORE. It is two-thirds of the world geographically.

Mr. RUTTENBERG. Yes, but not in terms of where American citizens are really living, carrying on their normal activities.

Senator GORE. Let's talk about—we have talked about the Ambassador.

What about the lowly stenographer in the U.S. Embassy? You would still allow her a $600 exemption?

Mr. RUTTENBERG. Well, I must say, that in my own mind I am a little confused at the moment as to whether American citizens working for the Government who reside overseas for more than 18 months, I am not clear in my own mind whether they are exempt from current taxes or not.

Senator GORE. They are not.

Mr. RUTTENBERG. The American citizen is not who works for the Government?

Senator GORE. That is right.

An American citizen who works for some private concern is. How do you justify that?

Mr. RUTTENBERG. Well, I don't, I would not. I think that is wrong.

Senator GORE. Well, you recommended, though, we give them an exemption for income up to $20,000.

Mr. RUTTENBERG. Well, I would apply it to any of our citizens, whether they work for the Government or don't work for the Government. I think that would be a degree of consistency which ought to be borne out.

Senator GORE. You can be proud of that one.

Mr. RUTTENBERG. Certainly I think our Government employees, as badly underpaid as they are, even with their allowances for living in hazardous areas or difficult areas of the world, they ought to be entitled to the same exemption in the less-developed parts of the world as an individual who works for General Motors or Standard Oil or any other corporation around the globe.

Senator GORE. Then you would take the position that a postal clerk in Miami would have an exemption of $600 but an employee in the U.S.——

Senator MORTON. The consulate in Nassau.

Senator GORE. Consulate.

Mr. RUTTENBERG. Consulate, Senator Morton says.

Senator GORE. The head of the consulate in Nassau would get an exemption of $20,000.

Mr. RUTTENBERG. Senator Goro, I would be glad to pursue this question with you; I think you have a good point and I am not at all interested in creating further inequities.

My only feeling in terms of this recommendation was if the bill stands as it is, and applies what we are talking about around the world all over this is much too much. We ought to, if there is any justification at all, it ought to be narrowed down to as narrow an area as you can and I, therefore, say put it in less developed areas.

If you want to take it away from them, too, I don't hold to that.

Senator GORE. I congratulate you, sir, we find that you are moving in the right direction.

Mr. RUTTENBERG. I thought we were moving awfully far in terms of saying that the bill as it came from the House and applied to the world was much too much. [Laughter.]

But I have already taken a lot of time, Senator, Mr. Chairman.

Senator GORE. So have I, I will quit.

Mr. RUTTENBERG. I just want to very quickly refer to the fact that we would very strongly urge you, as we do in our statement, to repeal the dividend credit and exclusion which President Kennedy recommeded for repeal last year, and which the House did not take action on.

It is true that $450 million is lost in revenue through this provision, and it is a provision which in the main is a glaring inequity in our Federal tax structure because it moves to a concept of giving a credit for unearned income.

We used to have a credit for earned income in American law. We abolished that and substituted for it years later this concept we adopted in 1954 in the Revenue Code, of credit for unearned income.

Now, if we really look at the problem, I guess one could put it most succinctly by saying that less than 6 percent of all American families own 64 percent of the value of all stocks, and when one really gets down to it, I have some very interesting tables which the Secretary of the Treasury also had in his testimony, these tables are in my prepared statement, and I might just call your attention to the table which really shows that the dividends on returns as a percent of total adjusted income are less than 1 percent for those people with incomes of less than $10,000, but they become anywhere from 32 to 52 percent for people with incomes above $100,000.

This is, it seems to me, a provision which hits at only a specific group of the population.

If I were to summarize these tables completely, I would say that the dividends obviously are highly concentrated in the upper income brackets.

Taxable returns of persons with incomes of under $5,000 constitute 41 percent of the total returns. These persons receive only 7 percent

of all the dividends and only 5½ percent of the dividend credit. In contrast, persons with incomes above $50,000 make up only two-tenths of 1 percent of all the income tax returns but they constitute one-third of the total dividends and constitute 36 percent of the dividend tax credit.

I would urge, Mr. Chairman, that in view of this, that the dividend credit and exclusion which was written in in 1958 ought to be currently repealed, and I would hope that the committee would include it in the bill as it reports it out.

I just wanted in passing now, as time goes on, to quickly say the dividend withholding and interest proposal which is in H.R. 10650 is a very good one.

The concept of withholding is a very old principle, old in the sense of having been applied in 1942 to wages and salaries in America.

Many States, including my good State that I now reside in, which is the State of the chairman of the committee, has applied withholding now to wages and salaries beginning January 1, 1963, and more and more States are moving in this direction, and I think it is about time that we applied the same concept of withholding to dividends and interest.

Certainly, only 3 percent of wages and salaries go unreported on income returns while 9 percent of all dividends and 35 percent of all interest goes unreported on all income tax returns for a total of $2.8 billion which go unreported on dividend returns now. If one were to close this loophole in the law, it would pick up some $650 million of revenue as the House bill does.

In my prepared statement, I deal with thrift institutions, with expense accounts, and lobby expenses. I might just say on lobby expenses we strongly urge that this provision be removed from the bill. It is a provision which, in effect, would permit corporations of America to double their amount of expenditure on lobbying, and thereby increase substantially their lobbying activities.

We think that there is no reason to give them tax exemption for lobbying expenses any more than there is reason to give the individual worker who pays dues to his organization the right to deduct expenses for lobbying activities.

The corporation ought to be on the same basis as the individual. The tax-free institutions, the nonprofitable institutions like the United States Chamber of Commerce, National Association of Manufacturers, American Farm Bureau Federation, AFL–CIO, other organizations have tax-exempt status and, therefore, their expenditures can be made on various activities.

Only a minor proportion of the AFL–CIO's expenditures are made on lobbying but that fits within the concept of a tax-free organization.

But as far as an individual union member is concerned, any portion of his dues which are attributed to lobbying is not a deductible item on his income tax return just as expenditures by corporations should not be as they are not now an item for deductible allowances. Under this bill such lobbying expenditures now not deductible by corporations would be permitted to be deductible and we think this provision ought to be removed.

We deal also in this testimony with the problem of having capital gains treatment for personal property extended to real property as

well. We agree fully with the recommendation of the Secretary of the Treasury on this subject and that it would probably be wise to return to straight line depreciation for real property as a means of getting around part of the depreciable asset problem on real property.

We would hope that the capital gains treatment would be removed from such privileges.

With that, Mr. Chairman, I might just point out that on the very last page of my statement is a summary of the eight specific recommendations which we make in the statement, and without going into those I thank you very much for the time you have allotted me this morning.

I have taken more than I should have and I apologize for doing that.

I appreciate the opportunity of appearing before the committee.

The CHAIRMAN. Thank you, Mr. Ruttenberg.

Senator CARLSON. Mr. Chairman, may I say, Mr. Ruttenberg, that I always appreciate your appearance before this committee. You are a very thorough and knowledgable student of taxes and always give us information that I think is very helpful.

I was not privileged to be present at the opening of your statement when you discussed the investment credit. I did hear the last part of it in which you mentioned that, I believe, that you were in favor of accelerated depreciation by selective industries.

Have you given enough thought to what these industries should be?

Mr. RUTTENBERG. Well now, Senator Carlson, let me make clear that we are not in support of accelerated depreciation. We think that if one were going to find a technique of encouraging certain industries the technique of investment credit is far better than the technique of accelerating depreciation.

The total effect to the corporation is the same in terms of the cash flow. It doesn't vary much. But in terms of the concept of a hidden as against direct open assistance the tax credit is far preferable.

And accelerated depreciation gets written in as a cost of doing business, and, therefore, gets into the price structure, and this would not necessarily be true of a tax credit.

But aside from that, assuming now that a tax credit is the technique you want to use in terms of the specific industries which we have suggested, you try limiting it to those that are actively engaged in foreign competition, just as we tried quite successfully, during World War II and again during the Korean war to apply a concept of tax assistance to those specific companies engaged in producing for the war effort.

I think that same concept could be applied to those industries engaged actively in exporting, such as the machine tool and the electrical machinery industry, and those industries actively confronted with import competition such as textiles and similar industries.

Having said this, let me say that we support the idea that Bulletin F ought to be revised, and that it ought to be revised to reflect as accurately as we can whatever the useful life is of a piece of equipment.

Bulletin F ought not to require a longer depreciation than actual life expectancy but it ought not to be revised in a way to produce a depreciation which is less than life expectancy. We think normal life expectancy ought to be determined and written into the regulations.

This is as far as we would go in the broad general approach to depreciation reform.

If you really wanted a place to apply the investment credit it should be directly in the export and import industry.

Senator CARLSON. Do you think our industry should be in position to meet competition in world markets today and increase our exports, first, of course, to furnish employment, second, to balance our payments?

How important do you regard that to be?

Mr. RUTTENBERG. Well, Senator Carlson, and I think I said it before you came in, we are not in a position of lacking competitive ability. If we could move from an export surplus of $1 billion in 1959 to an export surplus of $4.8 billion in 1960, to an export surplus of $5.5 billion in 1961, we have not exhibited any lack of competition, particularly if we look at the fact that of the $5.5 billion export surplus in 1961 more than $5 billion came from a surplus in manufacturing exports over manufacturing imports.

So we are competing actively and effectively in manufacturing around the world.

Now, therefore, we don't need it for that purpose.

I do agree that in terms of our balance of payments problem, that we have to maintain an export surplus. I am not so sure that it is wise to maintain an export surplus of larger than the one we have been having in the last 2 years, around about $5 billion or $5.5 billion. If we do we are going to get into the problem of denying many friendly nations around the world their opportunity to maintain export surpluses which they need to keep their economies healthy.

But I don't think, if we look at our 1961 balance of payments problem, it is as serious as it is made out to be. The $2½ billion unfavorable balance of payments in 1961 turns out to be only a $600 million basic deficit, if we remove the short-term flows and if we really look at the accounting principle involved.

The Japanese loans of some $800 million which are recorded as an outflow of dollars, are basic assets to the banks that made those loans, and they ought not, therefore, to be reflected as part of an unfavorable balance of payments because those dollars remained in the United States and are used to pay for Japanese purchases in this country. Yet our balance of payments bookkeepers calculate them as being an outflow of dollars.

Well, this just goes to exaggerate our unfavorable balance of payments and make people feel we have to do more to increase exports, et cetera, when it isn't true.

Senator CARLSON. You do realize, of course, that our gold reserves are down to $16.6 billion, and that we have a currency requirement of probably $11.8 billion, and we don't have, therefore, but $4 billion or $5 billion, maybe 5 of free gold, and it has been diminishing rather rapidly, and based on this last quarter it is still continuing to go down.

Mr. RUTTENBERG. Well, I could comment on the gold situation if you would like.

The hour is getting late but I would be perfectly happy to discuss it if you would like.

I think frankly we would strongly recommend removal of the 25-percent limitation against outstanding currency of the Federal Reserve System and thereby make our entire gold supply available as backing for our foreign assets in this country, plus the gold that we have on deposit at the World Bank. The International Monetary Fund ought also to be made available. I don't see what is wrong with a situation in which our gold supply is about $17 billion or $18 billion or more than that, if we consider the assets we have on deposit with the World Bank, et cetera. We then have more than 100 percent reserve against the short-term dollar holdings in this country. We don't operate a 100 percent reserve system in terms of our currency for our banks, why do we have to operate a 100 percent reserve of gold against the outstanding short-term securities in this country.

I think if we operate a fractional reserve system in our banking structure we ought to be willing to accept a fractional reserve system in terms of our dollar holdings versus our gold.

Senator CARLSON. Mr. Chairman, Mr. Ruttenberg and I could discuss that for some length so I will pass on.

Mr. RUTTENBERG. I am sure we could, Senator Carlson. Thank you.

The CHAIRMAN. Mr. Ruttenberg, I understood you to say the export surplus was $5 billion, is that correct?

Mr. RUTTENBERG. The export surplus total in 1961 was about $5.5 billion, yes, sir.

The CHAIRMAN. Did that take into consideration the food and other things that we did not receive payment for?

Mr. RUTTENBERG. It does take into consideration the Public Law 480 selling of foodstuffs overseas, for local currencies.

And it——

The CHAIRMAN. Local currency doesn't come back to this country. If you take the dollars that come back, I think you will find instead of $20 billion, as a number of newspapers have published, it is about $17.5 billion.

You might check on that and see——

Mr. RUTTENBERG. If you make allowances for Public Law 480, the export surplus dollarwise is not as great; you are perfectly right, Senator.

The CHAIRMAN. But when you get foreign currency, that foreign currency doesn't come back here in the form of dollars. I just wanted to get that straight for the record.

I think our export balance is not as much as you indicated.

Senator Gore, do you have any questions?

Senator GORE. No, sir.

The CHAIRMAN. Senator Bennett?

Senator Morton?

Senator MORTON. Just very briefly, Mr. Chairman.

Getting back to the tax on foreign subsidiaries of American corporations, I agree with you on this question of the third country in the tax haven and I hope we can do something about that, but it is my impression that most foreign investments—most of our American companies making investments overseas do so with a profit motive and they want to get the profit back, and I think actually 53 percent of the earnings in Europe of American companies have been recovered, or a ratio of about that for the last few years, and that is about the practice here at home.

In other words, most corporations after taxes pay out about half of what they earn in dividends and one form or another and retain the other half for the expansion of their business.

Now, I think it is historically true that exports of American-made goods have followed the investments of American industry abroad.

In 1960 the figures show that the foreign subsidiaries of American firms accounted for the sale abroad of $2.7 billion of products made in America.

These same firms brought $475 million back into this country. In other words, exports developed by our foreign subsidiaries amounted to almost six times the imports, and I think this helps to build American jobs, and I think that it is an important factor in our exports, the influence of investments abroad.

Don't you think there is a connection between the two?

Mr. RUTTENBERG. Senator Morton, I was very much impressed with one of the exhibits contained in Secretary Dillon's testimony on Monday in which he illustrates that, if I recall the figures correctly, if you take Western Europe and Canada combined that for every dollar of investments going overseas there is a 4-cent net export surplus flowing from this, and that this is a very minor proportion of—minor return on the dollar investments as contrasted to Latin America, where for every dollar invested you get a 40-cent net export surplus.

So that I think the concept of trying to take the tax deferral away from the developed countries and applying it to the less developed countries will cause a greater degree of net export surplus flowing from dollars invested in less developed areas, and I think the statistics in exhibit 3 of the Secretary's statement on Monday clearly illustrate this, and I very carefully have studied these figures, and they seem to me to be exceedingly valid.

Senator MORTON. Well, there seems to be a good deal of disagreement downtown on these statistics and their interpretation.

March 16, the Secretary of Commerce said that—

U.S. investment abroad is important to our export expansion program. Direct investments in manufacturing facilities abroad stimulate our exports of capital equipment, our exports of parts and raw materials, and our exports of finished products to fill out the lines of subsidiaries producing and selling abroad.

Our overall economic objectives require the continued expansion of U.S. investment.

He makes no differentiation between developed and underdeveloped countries, and the facts are that these subsidiaries—and most of that is shipped to the subsidiary, component parts and things of that kind—it is not a sales organization that is run parallel to the subsidiary.

It is true in the development of a subsidiary that manufactures a certain item, other items of the parent company would go along with that and that would stimulate the sale, but in any event it is because of the existence of that foreign subsidiary that we have, that accounts for many of our exports to Western Europe, and I don't want to see us take any steps here that will prevent that foreign subsidiary to impair its ability to compete, not with American companies, not with American jobs, but with jobs there in that country, in the business they do in third or other countries, and I am just afraid that by following a tax program here which is certainly unusual, with no precedent

for it at all and some even question of its constitutionality—that in following a tax program here we are jeopardizing American jobs that we see represented in the form of exports.

Mr. RUTTENBERG. Of course, I hope that the constitutional argument has been—I am no lawyer—but I trust it has been dispensed with by the people who have carefully looked at the problem.

We have foreign personal holding company acts applying to income through foreign personal holding companies overseas that Congress adopted many years ago.

They have been challenged and have been held to be constitutional, and I think it is the same concept which has applied to a foreign corporation, foreign subsidiary, but I do think there is no inconsistency, Senator Morton, between what Secretary Hodges has said and what Secretary Dillon has said, and far be it from me to reconcile the various points of view of various branches of the administration on figures, but I think it is clear there does flow from a dollar invested overseas a net export surplus. This is true.

But I think the figures illustrate that there is a 10-to-1 greater ratio from the exports which flow from a dollar invested in a less developed country to a dollar invested in a developed country; namely, because the developed country frequently sends back to the United States a large proportion of its production, and therefore this is subtracted from the exports which we send to that subsidiary. As a consequence, the net export surplus is 4 cents on every dollar invested in Europe and Canada, as against Latin America which exports very little back to the United States in the form of its product, and therefore the net export surplus in Latin America is 40 cents to the dollar.

Senator MORTON. Are you talking about what the country sends back to this country or what the American subsidiary operating——

Mr. RUTTENBERG. The American subsidiary.

This is the net export surplus as calculated on the basis of what that subsidiary buys from us and in terms of what that subsidiary sends back to the United States, and this is where the 40 cents and 4 cents come from.

Senator MORTON. The fact, however, remains that the exports even to Western Europe of manufactured goods, and the return of manufactured goods from those subsidiaries, is in the ratio, if we consider all subsidiaries in Western Europe alone, $712 million for our exports, $96 million for our imports.

If we consider only manufacturing subsidiaries in Western Europe, exports amounted to $291 million and imports to $90 million.

If that difference of $201 million represents only 4 cents on the dollar, of course, obviously we have a substantial investment and I assume that those figures of the Secretary's are right and it means we have an investment of 25 times 2 or some $50 billion, wouldn't it?—$5 billion or $50 billion overseas—$5 billion it probably is in Western Europe—that is $200 million times 25.

And that may be—that probably is our investment in the area of $5 billion overseas.

Mr. RUTTENBERG. $5 billion; because our total foreign investments are about $50 billion. U.S. foreign investments in American subsidiaries overseas gets to about $50 billion currently.

Senator MORTON. Nevertheless, whether it is 4 cents on the dollar or 40 cents on the dollar, the amount of our exports to Western Europe is quite large, and does make for many American jobs.

Mr. RUTTENBERG. But Senator Morton, all that is being said by this proposal to remove tax deferral is simply let the tax situation be neutral.

Let there be no consideration in terms of the American company investing overseas as to what its advantage would be because of taxes.

Let it make that decision to invest in Europe because it either wants to get there to produce for a third market or wants to get there to produce to get behind the external tariff of the Common Market or for any such other reason.

But I think it is awfully important to keep in mind that all we are saying is, if this is going to be a tax incentive entering into investment decisions, let it enter into the investment decision which takes American investments to the least developed countries where they are needed far more than to the developed countries where they really aren't needed.

Senator MORTON. All right, you use the word "neutral." We could use the word "equal."

Now that American company in France that is doing business in north Africa and elsewhere is competing with French, German, or British companies, and I say give them an equal opportunity to compete with the companies in the countries in which they are operating and then they will use American components, then they will use American parts and stimulate American exports and American jobs.

Yes, you want to make it neutral, you want to give him equality with a company producing here. But that doesn't give him equality with his competitor. His competitor is the French company or the British company, and yet he in the case of the manufacturer of mining machinery, say, would be bringing many American components, component parts made by American labor or in American factories, and American foundries to this point in France or elsewhere where he is competing with a French company and then you want him to have a tax structure which is not competitive with the French structure, let's say, but the structure of this country. He pays the French tax anyway.

Another thing, we get so, it seems to me, misled on this balance-of-payments things as to our investments versus our recoveries, in the decade of the 1950's we had terrific investments abroad, that is based on past history, and yet we recovered in that decade in profits that were paid back here, so some of these companies put something into tax haven and deferred payments for one reason or another. I am for getting at this third country thing just as everybody else.

But the fellow not using the third country, they brought back $20 billion in a decade, we invested a total of $12 billion, so that we actually from profits rendered abroad recovered in dollars $8 billion more in the 10 years than we actually invested out in capital investments.

Now American industry can't do anything like that here at home and that was a contributing factor in keeping the balance-of-payments programs less out of line than they were in the decade.

Mr. RUTTENBERG. Well, Senator, I think a very good argument can be made for the fact that one cannot look at the total outstanding

American investments and decide what the dividend return is and the earnings are on the total investments, that the dividends that come back to the United States and then say, say in the year 1961, I think it turned out to be $2.6 billion returned to the United States on American investments overseas and during the year 1961 we invested only $1.6 billion overseas, and, therefore, the conclusion is, "Well, look in terms of our balance of payments. This was a favorable billion dollar return to the United States."

But it isn't fair to make that kind of a comparison. What is the return to the United States in this year, 1961 or 1962 when we have the balance-of-payments problems we have from the $1,600 million that was actually invested and I think as the Secretary of the Treasury pointed out in his testimony on Monday, that it would take until the year 1975 before that billion and a half invested in 1961 produces a return which exceeds the amount of the outflow.

Now it is all well and good to talk about returns from past investments but if we are confronted now with an excessive outflow of private capital in terms of our balance-of-payments problem we ought to look at what is the return from the dollar outflow last year and it isn't until 1975 that we recover it.

Senator MORTON. Well, I mean you don't expect in this country or anywhere else to make a capital return in the year in which you invest the capital, but—and I must say I don't follow the Secretary's apprehension on that point, because I think that as long as we are getting back a return and we have been doing it for the past 10 or 12 years, greater than the outflow of capital, and we know that in future years that will continue to prevail unless the pattern changes, I mean if you follow your argument, I should think we would probably instead of approaching this from a tax angle just embargo the capital investment in developed countries with U.S. capital, try to stop it that way.

Mr. RUTTENBERG. Of course, this is what many of the countries in Europe now do, and the Continent including Great Britain, they do have very strict controls over the outflow of capital.

Nobody is suggesting that here in the United States, at least not now and I don't think it will be suggested.

Senator MORTON. I think this tax proposal may well reach that indirectly, reach that same end or develop that same thing as a matter of national policy.

Mr. RUTTENBERG. You see, Senator Morton, the tax proposal only says, let taxes not be a factor that enter into the decision.

Let the decision be made because there is need for capital receipts for other purposes, not for the purpose of having a tax advantage and that is all this proposal does and it gets only to that point and I think that is what ought to be kept in the forefront of our mind as we look at it.

Senator MORTON. But it would not apply in Puerto Rico or the Bahamas and places of that nature.

Mr. RUTTENBERG. Well, we get into the Puerto Rico versus Bahama problem again.

Senator MORTON. I don't care about pursuing that. But we have a plant in Louisville, the International Harvester, that does a substantial export business in South and Central America.

I don't know, but it accounts for the major operations of that plant, I don't know whether it is a major but an important percentage of the operations of that plant.

And I am concerned that the thing might well be, after Senator Bennett pointed out all the advantages that they would have, I am afraid if they read this testimony they might think of locating that plant in Puerto Rico.

It is all right if they want to put another one but I want to see my people in Kentucky keep the jobs.

Mr. RUTTENBERG. If the government of Luis Muñoz-Marín of Puerto Rico follows the regulations as vigorously as he has now it would be a new plant and not a substitute one of Louisville in order to get the tax advantage.

Senator MORTON. A new plant to take our customers away?

Senator BENNETT. A new plant in 1962 and then by accident the Louisville plant is closed in 1964, a situation that could easily happen.

Senator MORTON. That is all.

Senator GORE. Mr. Chairman.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. Senator Gore.

Senator GORE. The 1961 report of the Du Pont Co. reported, and I am quoting, "substantially" increased profits of foreign subsidiaries. They reported that foreign business rose to $368 million, but at the same time exports fell 12 percent below 1960 to $192 million.

Mr. Chairman, Mr. H. J. Heinz, Jr. gave some very interesting testimony and statistics in appearing before the House Ways and Means Committee last year, and I hope that when that gentleman appears here he will be prepared to answer a series of question with respect to his statistics and the companies that he purportedly represented.

I would like to cite, Mr. Ruttenberg, that among 82 of the large U.S. corporations, 5.2 percent of their total assets in 1950 was in foreign investment.

By 1955 that had increased to 7.2 percent.

By 1960 it was 9.8 percent.

By 1962 it is much more.

Among 81 large U.S. companies, foreign sales as a percentage of total sales amounted in 1950 to 7 percent, in 1955 to 10 percent; 1960, 12.2 percent.

Let's take 73 so-called blue chips: In 1950, 7 percent of their profits were earned abroad.

In 1955, 11 percent. In 1960, 14 percent. Yet it is seriously advocated here that we continue to give tax deferral on the profits earned abroad.

It is seriously argued that we continue this deferral which in many instances amounts to tax exemption.

Among 75 firms with substantial foreign sales, goods produced in foreign plants, as a percentage of total sales abroad, in 1950 was 36 percent. I assume that the 64 percent of foreign sales would come from exports from the United States.

By 1955 sales from their plants abroad had increased to 56 percent, and I take it their sales from exports here had been reduced from 64 to 44.

By 1960 goods produced in foreign plants had increased to 68 percent of their total sales abroad.

Now, those statistics hardly bear out the contention that we are increasing American employment and the strength of American industry by tax subsidy to plant expansion and investment abroad.

Senator MORTON. Will the Senator yield?

Senator GORE. Yes.

Senator MORTON. Have you got the total dollars for exports that you mentioned?

Senator GORE. On these particular plants? I have it in percentages before me, not in dollars.

Senator MORTON. You have it in percentages because those plants are growing abroad. The fact that the percentage of American exports to their total business went down doesn't necessarily mean that the exports of American products abroad by those plants in dollars and in American jobs went down.

Senator GORE. As a matter of fact, what I have just cited is that the goods produced in foreign plants as a percentage of goods sold abroad by these companies increased from 36 percent in 1950 to 68 percent in 1960, 10 years.

Senator MORTON. I don't question that.

My point is that these businesses were expanding so that the figure that is left, the residue that is left after you take the amount that they manufactured as a percentage of their total business, could have well been expanding even though percentagewise it was going down.

Further, the component parts used by these companies abroad to build up from 32 to 65 percent, or 68 percent of their business abroad with products manufactured abroad could well have increased substantially and added to the exports from the United States and to goods manufactured in American plants and with American labor.

Senator GORE. What you are saying, as I understand it, is that the businesses may have grown in the United States at the same time the foreign subsidiary was growing.

Senator MORTON. No business is abroad.

Senator GORE. And that their exports may have increased at the same time.

Senator MORTON. Exports of finished goods and component parts.

Senator GORE. This may be true. But the fact stands that the rate of expansion of U.S. business abroad has greatly exceeded the rate of expansion of U.S. business in our own country.

Senator MORTON. That I fully recognize and had it not expanded, who would have had the business, France, West Germany, Great Britain, Italy?

Senator GORE. And one of the reasons why the expansion of U.S. investment abroad has greatly exceeded the growth of U.S. investment at home, is the tax subsidy which operates as a lodestone, as an incentive, and it is that which I desire to remove and which, as I understand, the AFL-CIO desires to remove.

Senator MORTON. I want to remove the tax inequities, the ability for avoiding any taxes through the third country, through haven countries, through the Swiss arrangements, and so forth.

But I don't see why American companies doing business in France should have, it is not a tax subsidy, it is a tax equality with the French company that is right around the corner.

Senator GORE. Well, you are comparing now a U.S. subsidiary in France with a French concern. We started——

Senator MORTON. That is the one he is competing with.

Senator GORE. We started out comparing a U.S. corporation in the United States with a U.S. subsidiary operating in a foreign country.

Senator MORTON. A U.S. subsidiary operating in a foreign country is competing with the nationals of that country.

Senator GORE. Yes, and they are competing with the nationals of our own country, too.

Let's just take this a little further.

Recently, the Ford Co. announced that it was going to manufacture a so-called American Volkswagen.

Mr. RUTTENBERG. The Cardinal.

Senator GORE. Well, the story, as I read it, was that this was to be something of an American equivalent of the Volkswagen.

Mr. RUTTENBERG. Yes, called the Cardinal.

Senator GORE. And it was to be produced by a foreign subsidiary, not manufactured in the United States. The automobile is to be manufactured abroad.

Mr. RUTTENBERG. They changed their mind on this, Senator. They are producing the engines abroad and are going to assemble it in Louisville, Ky. [Laughter.]

Mr. RUTTENBERG. At least that is the current announcement of the Ford Motor Co., the car and some engines will be made in Germany.

Senator MORTON. It is the hope in Louisville they change their mind. We went through this with the Edsel. They closed down the Ford plant and started making Edsels and we don't want to go through that again.

So we want the Ford Motor Co. doing just what it is doing in Louisville.

Senator GORE. This is not the only automobile, or automotive parts, being manufactured abroad by U.S. corporate subsidiaries, and imported into the United States.

So, I say to my friend from Kentucky, that these foreign subsidiaries are not only competing, and competing successfully, with foreign corporations, but they are competing with U.S. concerns by importing back into the United States, on the one hand, and taking customers that formerly were supplied by exports from the United States, on the other.

So this is a three-step operation, and we are coming out on the little end of it, and why we want to penalize the establishment of a factory in Louisville and reward the establishment of one in West Germany, I just don't understand.

Of course, you and I could discuss this at greater length, I take it, on the floor of the Senate.

Senator MORTON. There is no use in debating it here, but in conclusion——

Senator GORE. It might serve a good purpose.

Senator MORTON. But the same companies that are bringing these $440 million—$450 million—a year, American subsidiaries bringing $450 million a year, into this country are also exporting from this country an amount six times that great and as long as we can hold a 6 to 1 ratio on this business—six American jobs for one over there—I think it is a pretty good deal.

Senator GORE. Let's just go ahead with the automobile industry for a moment.

How many automobiles does the United States export to Western Europe?

Senator MORTON. I don't know.

Senator GORE. How many are imported here?

Senator MORTON. From U.S. subsidiaries?

Senator GORE. Yes, from U.S. subsidiaries—automobiles, automotive parts.

Senator MORTON. I don't know, I assume we can get the figures from the Department of Commerce.

Senator GORE. They wouldn't substantiate the figures you have just stated.

Senator MORTON. I am citing the overall figure.

Senator GORE. I am not sure you are giving the proper interpretation to the statistics.

Mr. RUTTENBERG. Could I just inject while you two gentlemen are debating this?

Senator GORE. This is a dangerous operation.

Mr. RUTTENBERG. I just want to point out——

Senator GORE. You know the story that is repeated many times of someone settling a family quarrel.

Mr. RUTTENBERG. Well——

Senator GORE. Go ahead. You are intrepid.

Mr. RUTTENBERG. It reminds me of entering where angels fear to tread.

In my statement I do make some comment on this particular problem which both Senator Gore and Senator Morton are talking about.

In our judgment about $3 to $5 billion worth of American exports are lost, $3 to $5 billion, are lost as the result of American subsidiaries abroad and this displaces 250,000 to 500,000 American workers.

Senator GORE. I thought we just heard that this increased American jobs at the ratio of 6 to 1?

Where did you get these figures?

Mr. RUTTENBERG. I agree with you, Senator Gore, I don't concur with that——

Senator GORE. Are these illicit statistics you are giving us?

Mr. RUTTENBERG. These are contained in my statement.

Senator GORE. That does not make them legitimate. [Laughter.]

Mr. RUTTENBERG. Statistics never lie but statisticians do.

Senator GORE. Where were they obtained?

Mr. RUTTENBERG. These are just estimates based upon an examination of the American subsidiaries overseas, and taking into consideration the amount of products which those subsidiaries draw from the United States, and the amount which they ship back and in turn the amount of markets which the oversea subsidiary furnishes either in Europe or in the third country markets. We could fulfill a large part of the demand of the third country and a large part of the demand of the countries where the manufacturing subsidiary is located if we produced the product in the United States rather than producing it over in France, Italy, Germany, or someplace else.

Now, granted we won't get all of the markets that those subsidiaries are now able to get, because to a certain extent they can produce them

slightly cheaper. But in the main, if we take the overall sales of these American subsidiaries overseas, and relate them to what we could supply if they did not have the tax advantage operating where they are, that if they were producing them in the United States we would get, in our estimate, between $3 and $5 billion increase in exports and provide about 250,000 to 500,000 additional jobs, and this would come about——

Senator GORE. Is that per year?

Mr. RUTTENBERG. No, this is the overall effect of removing the tax deferral. This is what would be our estimate of what would come about by a removal of the tax deferral. This isn't each year. It is the aggregate amount that currently we are losing. Currently we are losing about $3 to $5 billion a year to exports per year.

Senator GORE. That is what I thought.

Mr. RUTTENBERG. As the result of this operation, and that that would provide about 250,000 to 500,000 jobs. But that would only be a one-shot operation.

The year in which it occurred it would then repeat itself year after year but it wouldn't each year add this much, is what I am saying.

Senator GORE. Let us look at it another way: How much overseas investment occurred last year?

Mr. RUTTENBERG. The net long-term capital, I think, in the balance of payments is $1.6 billion for 1961, if I recall correctly.

It takes out capital that is invested in bonded equity, but long-term private investment in plant and equipment was, I think, $1.6 billion in the balance of payments for 1961.

Senator GORE. What kind of stimulation would we have had in this country had this $1.6 billion been invested here?

Mr. RUTTENBERG. I think it would have been quite substantial and significant, and had we had a growing and expanding economy in the United States then instead of the capital flowing overseas, looking for a place to be invested, it would have been invested in the United States.

Senator MORTON. It wouldn't have been invested, however, had it not been a profit opportunity for the capital?

Mr. RUTTENBERG. That is right, it would not.

Senator MORTON. There is no shortage of capital in this country. They will invest in this country as soon as there is a profit opportunity; plenty of capital.

Mr. RUTTENBERG. Exactly right. Therefore, we don't even need the investment credit, do we?

That gets us off on another subject.

Senator GORE. I didn't mean to shut him off from answering.

I recently——

Senator MORTON. Our party agreed with you in the House on investment credit.

Mr. RUTTENBERG. For different reasons, Senator Morton.

Senator GORE. I recently was a seatmate on a plane ride with the president of one of the largest shoe manufacturing concerns in the world. We talked for a period of 2 hours, and we discussed this problem.

I shall not name the man or the concern. Our talk was personal. He did tell me of enormous plans to build foreign subsidiary plants

and import shoes into this country, replacing shoes that we would hope would be manufactured in this country.

Now, that is something which is anticipated.

I would like to ask you now what has happened to the manual typewriter industry?

Mr. RUTTENBERG. Well, of course, there is an interesting story to be told in terms of what the Olivetti Co. of Italy did when it came into this country and bought control of the Underwood Corp. in Hartford, Conn. They have almost tripled employment in the Hartford plant under new management, and are now producing typewriters in competition with typewriters produced overseas because they brought in some new modern techniques of operation. They also brought in some ingenious new blood. They happened to be Italian management people who came in, and they have put Underwood back in operation so that they are now producing typewriters and shipping them, increased their sales in the United States, and are also shipping them and competing in Italy with typewriters made by Olivetti in Italy.

Senator GORE. Is that the manual or electric?

Mr. RUTTENBERG. Those they are shipping to Italy are the electric.

Senator GORE. Well, I asked you about the manual typewriter industry.

Mr. RUTTENBERG. Well, it is interesting that Sperry Rand which took over the Remington typewriter, decided about 2 or 3 years ago that they were going to go abroad and produce typewriters. All of a sudden they decided maybe they ought not to do that and do it in this country because it is possible to produce efficiently, if they only changed their methods and improved their product.

I don't know to what extent this has proved true in the Remington case, but certainly the Underwood people, the Olivetti people, are producing manual typewriters in this country and selling them in this country with the competition with the Olivetti produced in Italy.

They are producing electric typewriters in this country and selling them abroad in Italy.

Senator GORE. So you maintain that the techonology and productive capacity, if utilized, is available in this country, and you advocate that we neutralize U.S. tax policy so that we not provide a reward, an incentive, a subsidy for the moving of manufacturing facilities abroad?

Mr. RUTTENBERG. Precisely, exactly, that is exactly what I am saying.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS. I notice in your statement you talk about expense accounts, and the sections, section 4 of the bill. I am glad you asked for a more rigid restriction than contained in the House bill.

The House bill permits a reduction if the taxpayer establishes that the item was directly related to the taxpayer's active conduct of a trade or business or the facility was used primarily for the furtherance of the taxpayers trade or business, the item was directly related to the active conduct of such trade or business.

Do you think that is a sufficiently rigid definition?

Mr. RUTTENBERG. No, Senator Douglas. We do not think it is sufficiently rigid. It lends itself to interpretation by the Internal

Revenue Service, and I think one of the big problems has been the indefiniteness of such a general statement in the past confusion of the Tax Courts. We have a most outstanding example of the milk distributor who had an African safari deducted as the cost of doing business of distributing milk in this country, upheld by the Tax Court.

And one of the purposes, of course, in trying to——

Senator DOUGLAS. The African safari was supposed to be conducive to an increased consumption of milk.

Mr. RUTTENBERG. He somehow took the pictures he took on the African safari as an aid in the distribution of milk in this country and this was supposed to be a direct connection.

Well, the Tax Court held it came under the rules and regulations as they were adopted. The statement in the bill now requires a little more direct relationship to the activity of the business.

Goodwill is removed. This is an improvement but not nearly enough of an improvement if we are really going to get at the serious problem of expense account abuse that exists in this country. We suggest going back to the original proposals made by the President a year ago in his message.

Senator DOUGLAS. Have you ever had occasion to go into the ruling of the Internal Revenue Bureau made in the case of the trip the American Bar Association made to London some years ago.

That was regarded as a tax deductible expense, was it not?

Mr. RUTTENBERG. Yes.

Senator DOUGLAS. Did this include deductions for the wives?

Mr. RUTTENBERG. I think that was—I don't recall the exact details now, Senator Douglas, but I think the wife probably was one of the issues that was raised as the result of the case, and as I recall, well, I had better not. My recollection might be wrong. I thought they disallowed the wife's expenses.

Senator DOUGLAS. I wondered if the staff could find out what the ruling was?

Mr. STAM. I think they disallowed the deduction for the wives.

Senator DOUGLAS. What about trips to Europe after the American Bar Association had finished its meeting in London?

Would you look this matter up?

The CHAIRMAN. Mr. Stam will look it up and make an insertion in the record.

(The information referred to follows:)

DEDUCTIBILITY OF CERTAIN EXPENSES OF ATTENDING AMERICAN BAR ASSOCIATION CONVENTION WHEN HELD IN LONDON, ENGLAND

A check with the Internal Revenue Service indicated that although there were two or three letters written by the Internal Revenue Service relative to the deductibility of travel expenses in connection with attendance at the American Bar Association Convention in London, England, they were not definitive; instead they indicated that it was a question of fact in each case. The American Bar Association Journal of December 1956 contained the following statement:

"ARE LONDON MEETING EXPENSES DEDUCTIBLE? REVENUE RULING 56–168

"We have been receiving many inquiries concerning the deductibility, for Federal income tax purposes, of expenses incurred by our members in attending the coming London meeting. In this connection we call attention to Revenue Ruling 56–168, I.R.B. 1956–17, 6. For the convenience of the members, that ruling is reprinted here in full:

" 'The question frequently arises whether the expenses of taxpayers and members of their families in making business trips and attending business or pro-

fessional conventions are deductible for income tax purposes, especially where opportunities exist for personal vacationing in connection with the trip or convention. The purpose of this revenue ruling is to set forth guides for taxpayers and field officers of the Internal Revenue Service in determining the allocation and deductibility of such expenses.

" 'Section 162(a) of the Internal Revenue Code of 1954 provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including the amount expended for meals and lodging) while away from home in pursuit of a trade or business. Only those expenses which are ordinary and necessary in the conduct of the business and are directly attributable to it may be deducted. See sections 39.23(a)-1, 39.23(a)-2(a), and 39.23(a)-2(f) of Regulations 118, which are applicable by virtue of Treasury Decision 6091, C.B. 1954-2, 47. Section 262 of the 1954 Code provides, with exceptions not here material, that no deduction shall be allowed for personal, living or family expenses.

" 'Where opportunities exist for personal vacationing in connection with business trips or the attendance of business or professional conventions, and especially where the taxpayer is accompanied by one or more members of his family, it is apparent that examining officers of the Service have a duty to give especially careful scrutiny to deductions taken in returns for the expense involved in order to assure against abuse of the deduction permitted by section 162(a) of the code. In those cases where a business purpose is served, it is also necessary to determine what portion of the total expense is deductible as an ordinary and necessary business expense and what portion represents nondeductible personal or living expenses.

" 'In those cases where a taxpayer makes a business trip such as attending a convention or other business meeting and, as an incident of such trip, engages in some personal activity such as sightseeing, social visiting or entertaining, or other recreation, that part of the total expense of the trip which is directly attributable to the taxpayer's business will be treated as deductible notwithstanding the incidental personal activity. That part of the total expense which is properly allocable to such incidental personal activities will be treated as nondeductible personal or living expenses. Where the purposes of a trip are primarily personal, the entire expense involved will be treated as nondeductible personal or living expenses notwithstanding that the taxpayer engages or participates in some incidental activity related to his business.

" 'Where a taxpayer's wife accompanies him on a business trip, those expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. See Rev. Rul. 55-57, C.B. 1955-1, 315. The wife's performance of some incidental service does not cause here expenses to qualify as deductible business expenses. The same rules are applicable with respect to any other members of the taxpayer's family who accompany him on such a trip.

" 'The application of the foregoing guides may be illustrated by the following examples:

" '(1) A taxpayer makes a business trip for the purpose of attending a convention held in a coastal city. During the period of the convention, he also engages in local sightseeing, entertaining, and visiting unrelated to his business. He also arranges to take a postconvention cruise made available to individuals attending the convention, the purpose of which is primarily recreational although some incidental sessions are scheduled for lectures, discussions, or exhibitions related to the business interests of the group holding the convention. The expenses paid for the local sightseeing, entertaining, and visiting and the entire cost of the postconvention cruise are deemed to represent nondeductible personal expenses.

" '(2) A taxpayer's wife accompanies him on a business trip, which may include his attendance of a business or professional convention. She occasionally types notes or performs some similar service and accompanies him to luncheons and dinners. The performance of such services does not establish that her presence is necessary to the conduct of the taxpayer's business.

" '(3) Under the circumstances involved in example (2) above, the cost of transportation and lodging exceeds the cost for single fares and accommodations but is less than twice the single rate. The amount deductible as an ordinary and necessary business expense on account of the transportation and lodging is the amount directly related to the business purpose of the trip, that is, the cost

at the single rate for similar accommodations. The amount by which the total expense is increased because of the wife's presence and the entire cost of the wife's meals are not deductible.'

"In view of the above, no special ruling will be requested by the association."

The current Treasury Department income tax regulations (1. 162-(d)) state:

"(d) Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense under section 162 depending upon the facts and circumstances of each case. * * * The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade or business and his attendance at the convention of other meetings so that he is benefiting or advancing the interests of his trade or business by such attendance."

With respect to travel expenses generally the regulations (1. 162-2(b)) state:

"(b) (1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

"(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends 1 week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional 5 weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary."

With respect to travel expenses of a taxpayer's wife the regulations (1. 162-2(c)) state:

"(c) Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses."

Senator DOUGLAS. Now, suppose a taxpayer claims that he likes to do business at a night club, at the 21 Club, for example, where I am told the checks are pretty high, and that this is a favorite place of business to discuss intercorporate dealings.

Do you think that language would disallow it?

Mr. RUTTENBERG. I think, Senator Douglas, that while the language says it must be directly related to the active trade or business, it would be very difficult to decide whether the taking of, say, a group of 25 people to a night club at the 21 Club in New York would be directly related to the trade or business.

I would hope that kind of thing would be disallowed as an expense, but it is questionable whether the language is strong enough to exclude it. This is the kind of an abuse we thought ought to be improved upon here in your committee.

Senator DOUGLAS. Now, I have a friend who is quite a successful corporation executive. He has an apartment in New York, an apartment in London, an apartment in Paris, a hunting lodge in Canada, and a resort in a State with lots of sunshine. I suspect in many cases he has taken some tax deductible expenses; do you think the language in the bill is sufficiently tight to take care of that?

Mr. RUTTENBERG. Well, the language in the bill is something of the order of saying the cost of the facility, say the yachting club or the hunting lodge or the apartment in London or Paris, would be deductible only if it is used more than half the time for business purposes.

Senator DOUGLAS. That is right.

Mr. RUTTENBERG. This is the way in which this problem is handled in the bill. I would hope that consequently—I don't see how a hunting lodge is used for more than half the time in business under the circumstances you describe.

Senator DOUGLAS. That is, you interpret it primarily to meet more than 50 percent?

Mr. RUTTENBERG. I think this is the way in which the report describes it, yes, the report accompanying the bill.

Senator DOUGLAS. You favor, however, a dollar maximum for food and lodging?

Mr. RUTTENBERG. Yes, we do, yes.

Senator DOUGLAS. How much is that?

Mr. RUTTENBERG. Well, in terms of travel expenses the President recommended a year ago that the amount permitted be double the amount authorized for Federal Government travel. That now being $16 of Federal Government travel it would be an allowance of $32 a day on room and board for direct travel expenses.

Senator DOUGLAS. Twice the standard of the Federal civil service?

Mr. RUTTENBERG. Twice the standard of the Federal civil service was the recommendation and we would suggest going back to it. The bill simply uses the word "reasonable" or some such term.

Senator DOUGLAS. What about business gifts?

Mr. RUTTENBERG. Well, business gifts, a gift is permitted up to $25, not to exceed $25.

Senator DOUGLAS. $25 a person?

Mr. RUTTENBERG. Per person, yes, per gift.

Senator DOUGLAS. Yes, per year.

Mr. RUTTENBERG. And that the President recommended a year ago that it be not in excess of $10 and we think this is a good proposal and we ought to go back to that in the bill.

Senator DOUGLAS. I don't know about comparative prices but this would permit a quart of whisky to be given as a demonstration of good will.

Mr. RUTTENBERG. Or 2 or 3 pounds of tea in substitute for the quart of whisky.

Senator DOUGLAS. That would be better yet. [Laughter.]

Mr. Ruttenberg, you get around a lot, do you think there are real abuses connected with gifts and expense accounts?

Mr. RUTTENBERG. I think there is a very serious abuse of this in all walks of life, and I think that it is a sad commentary in our economy today that the average taxpayer who doesn't get around and can't take advantage of expense account living, has to have his taxes increased to offset the deductions which those who can afford to travel and take the expense allowance yet.

Senator DOUGLAS. He really pays 52 percent of the check, doesn't he?

Mr. RUTTENBERG. Right, that is right; and the more deductions that come from expense accounts the greater the Federal revenue has to

be from other sources and the other sources are the average men in the street who have to pay it.

Senator DOUGLAS. Mr. Ruttenberg, one of the important unions in the AFL–CIO is the Hotel and Restaurant Workers Union and the restaurants are complaining that through rigid restrictions on expense accounts and lodging and meals, that waiters and musicians and entertainers are thrown out of work.

Mr. RUTTENBERG. This is certainly an argument which I have heard made by restaurant owners as well as by some of the unions, affiliated with AFL–CIO in the entertainment field. Our general position has been that we do not think a person's job ought to depend upon an improper tax subsidy which is given to individuals who can afford to take the expense account allowances.

We think if we got back to a normal operating economy where people go to lunch or do entertaining or go to a sports event on the basis of paying the price involved, rather than the price being twice or three times what it normally should be because folks know it is going to be tax deductible, more people might be able to participate in athletic or theatrical events and prices may well come down because then the theater owners or the restaurant owners would not be able to rely upon expense accounts to get the high prices they charge. In the long run maybe a tightening up of the expense account allowance may be far more beneficial to the rank and file worker in the hotels and restaurants by reducing prices but increasing customers.

Senator DOUGLAS. May I ask a question on section 3 on lobbying?

Mr. RUTTENBERG. Yes, we suggest in our statement that this provision be removed both for substantive and procedural reasons, and I explained a little of this in my statement toward the end, I think when you were out of the room, Senator.

Senator DOUGLAS. May I ask this: If a group of citizens are opposed to a bill which a group of corporations favor, under this language the corporations could deduct the direct expenses connected with appearances or communications?

Could the citizens make similar deductions under our law? Could they be said to have a material interest which would permit them to deduct expenses, travel expenses coming to Washington, preparation of briefs, and so forth?

Mr. RUTTENBERG. As I understand the bill as it is now written, and I would defer to the experts on this, it would apply only to the business expenses of corporations and not to the expense of individuals, private individuals who are coming to testify.

Senator DOUGLAS. I wonder if Mr. Stam and the staff would clarify this point?

Mr. STAM. I did not hear you.

Senator DOUGLAS. The question is whether the deductions allowed in connection with legislation under section 3 apply only to those carrying on a trade or business which has a material interest in connection with legislation or whether they are also permitted for citizens having only an indirect interest as consumers or as taxpayers or having only a moral interest in the matter.

Mr. STAM. I think the purpose of the amendment was that you had to have in mind a specific matter that affected you personally, your business, I mean.

Senator DOUGLAS. Has affected you economically?

Mr. STAM. That is right.

But you could deduct it, that is the idea.

Senator DOUGLAS. Would a taxpayer be considered, an ordinary taxpayer be considered, to have a material interest in the tax bill?

Mr. STAM. Well, it would have to be a direct interest that affected his particular problem. In other words——

Senator DOUGLAS. In effect what you are saying is that lobbying expenditures for the general interest are not tax deductible, but lobbying expenses for special interests are deductible, is that right?

Mr. STAM. Well, I mean, for example, if you went to see a Member of Congress and you wanted to talk about a specific tax proposal that affected you personally, then that would be considered to be a business expense, and allowed.

Senator DOUGLAS. Yes, such as corporations doing business abroad.

But suppose you are just a citizen interested in this matter, and you feel that if this privilege, to which the Senator from Tennessee has referred, is granted to corporations abroad, it would have a generally adverse effect upon the country.

Would your expenses under those conditions be deductible?

Mr. STAM. I would think no, Senator Douglas, the connection is too remote.

Senator DOUGLAS. That was my feeling.

Senator BENNETT. Would the Senator yield so I can cite him another example?

Suppose you were the president of the League of Women Voters of Salt Lake City and you wanted to come to Washington to testify before any committee of Congress on any pending legislation, could your expenses be deducted?

Mr. STAM. I think you would have to show some direct interest in that legislation that would have some specific effect upon you in connection with your business.

Mr. RUTTENBERG. There is a provision here, I was just looking at the report, I am not sure I understand it but it says the deduction of legislative expenses for those who incur them for personal reasons is not proposed here since such expenses are not deductible.

Senator BENNETT. I didn't indicate somebody who was doing it for personal reasons. I indicated an example of a person who was a member of a national organization, nonprofit, who comes representing the organization to an appearance before a legislative committee.

Senator DOUGLAS. What was Mr. Stam's answer?

Mr. STAM. Well, all of those questions will have to be interpreted but I mean you are supposed to have some direct interest in the particular legislation.

Senator DOUGLAS. What is your definition of "direct"?

Mr. STAM. Now, if this particular person was hired by an organization to come before the Congress and make a statement affecting the proposed legislation, I would think it would be deductible.

Senator SMATHERS. In this summary right here, I just saw this, Mr. Chairman, it says here if the expenses are otherwise a deduction allowed for the portion of dues paid to an organization which are used for similar legislative expenses to the extent they are related to the business of its members. It goes on to say in addition the expense

of communication of information between the taxpayer and the organization with respect to legislation is deductible.

So the illustration which the Senator from Utah gave according to this summary would be deductible.

That is what it says.

Stam says, "Yes" and the other man says, "No," so I don't know.

Mr. RUTTENBERG. The best thing to do is just remove the whole provision from the bill which we strongly urge you to do.

Senator DOUGLAS. Did you hear testimony from the U.S. Chamber of Commerce yesterday that the language still be further broadened to include expenses to inform not only legislators but also the general public?

Mr. RUTTENBERG. This was a proposal which the Ways and Means Committee was considering back, I think, in 1959 and 1960, and rejected out of hand and this proposal specifically does say in the report on it by the Ways and Means Committee that such expenses obviously are not covered by this proposal but I do know the Chamber and a good many other organizations are interested in expanding it out which would be a very serious problem indeed.

Senator BENNETT. That is all, Mr. Chairman.

The CHAIRMAN. Senator Gore?

Senator GORE. I have one more question.

In order that there will be no misunderstanding about the position you have taken, I believe you said you did not wish to impede foreign investments by U.S. corporations.

Mr. RUTTENBERG. That is right, I agree.

Senator GORE. You only wish to remove the premium upon income from foreign investments?

Mr. RUTTENBERG. Exactly.

Senator GORE. The preferential tax treatment?

Mr. RUTTENBERG. Right.

Senator GORE. It is not your view, is it, that a removal of this preferential treatment would stop all foreign investment?

Mr. RUTTENBERG. I am sure it would not, because there are other, many, many legitimate reasons for foreign investment to move overseas and we think they ought to move overseas but they ought not as you say have the tax advantages as an additional incentive.

Senator GORE. So this is not a question of discussing the extremes of whether or not there will be no foreign investment for U.S. concerns and citizens on the one hand, or whether there will be a flood on the other.

It is a question of putting the American tax, U.S. tax policy, in a position of neutrality; in other words, of repealing preference, the favoritism now given to foreign income?

Mr. RUTTENBERG. Exactly, Senator Gore.

You have restated my position quite accurately.

Senator GORE. Well, I wanted to restate it because it is my position also, and I did not want to run the risk of someone misinterpreting it.

I would like to go one step further. You said that there was no regulation now on exporting capital. That is correct. Will this not, in your opinion, become almost inevitable if the tax favoritism on foreign income is continued?

Mr. RUTTENBERG. I am inclined to agree with you, Senator Gore, that if we continue tax deferral and continue the kind of increases in tax havens as well as increases in the number of manufacturing productive facilities overseas that this may well force the United States into a position of some control over the export of capital and I think this would be disastrous and I think we ought to avoid that by removing the tax deferral before it happens.

Senator GORE. I am not sure that it would be disastrous, but I do feel that it may be the inevitable consequence of continued preferential tax treatment of foreign income. It may be a necessary action if our balance of payments difficulties continue in their present severity, and particularly so if that becomes more severe. I am not at all sure it would be disastrous, but we are the only major industrialized nation in the world that either does not now or has not in the past used it. I don't know why we should be so frightened of it and, therefore, I couldn't agree with you that it would be disastrous.

It might be very helpful, in fact. But at least the point I wanted to make was that if we don't have it now, if we continue this unwise preferential treatment of income and profits earned abroad, then it may make direct regulation inevitable, whether it is very bad or just bad.

Mr. RUTTENBERG. I used the term "disastrous" in the sense that normally in America we abhor the notion of controls in America, and if we want to avoid the necessity of controls in the years to come, over the export of American capital, the way it seems to me to do that is to remove the tax deferral privilege now and I used the word "disastrous" only in that context.

Senator GORE. Thank you.

Mr. RUTTENBERG. You would have to resort to controls.

The CHAIRMAN. Mr. Ruttenberg, I want to congratulate you on making a very fine statement, able and constructive. It is very evident you are quite a student of taxation and we are always glad to have you before the committee.

(The prepared statement of Mr. Ruttenberg follows:)

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR OF RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

On behalf of the AFL-CIO, I wish to express appreciation to the chairman and members of the Senate Finance Committee for this opportunity to present our views on the proposed Revenue Act of 1962. Your committee is confronted with vastly complex tax issues which vitally affect the welfare of this Nation.

The AFL-CIO supported this bill on the House side with considerable reservation. While it includes features that are highly praiseworthy, in our judgment some of its provisions are not in the public interest. Besides, there are regrettable omissions. We are confident, however, that a vastly improved measure will emerge when this committee has completed its deliberations and reports its bill.

The most encouraging aspect of the President's tax message of April 1961 was his call to the Congress to start closing loopholes. Taking action to end legal and illegal tax evasions—even though only the few that the President singled out for congressional consideration a year ago—would be a hopeful although belated beginning of tax reform. Only when loopholes are closed and the billions of dollars lost by the Treasury each year are recouped, can Congress afford to significantly lighten the near-wartime tax burden still being imposed upon the average American family.

We are thankful, therefore, for the beginning of loophole closing undertaken by this bill. Unfortunately, its provisions would achieve less than two-thirds of the not even $2 billion loophole closing goal set forth by the President. We ask

you now to go the rest of the way. Achieving his limited objective is necessary not only to restore greater tax equity and to regain needed revenue; it is necessary also to preserve the respect of Americans for their tax system. Later in this testimony we will discuss precisely why we urge that this bill be modified to close various loopholes in essentially the manner proposed by the President. At this point, we wish to address ourselves to the manifold reasons why we oppose the investment tax credit proposal.

THE INVESTMENT CREDIT

At the outset, we wish to make one lauditory comment about this ill-conceived proposal. Its authors are to be commended, at least, for their recognition that fiscal policies can and must be shaped to achieve more than the traditional objective of raising adequate revenue and doing it fairly. Just as fast tax writeoffs served successfully to spur defense-related construction, special tax concessions are wisely granted to encourge small business and temporary tax cuts to counter future business downturns are now properly being supported by the President—practical new fiscal tools must be conceived and used to achieve priority national goals as the need arises. Although we view the investment credit to be an undesirable tax device, we recognize the values of the search for new and imaginative fiscal policies to help solve pressing problems.

It is being argued by the administration that this costly credit is vitally needed to sitmulate capital investment and, particularly, to increase our ability to compete overseas. It is our view that this super-billion-dollar permanent subsidy—which will absorb all the revenue from loophole closings—will do little to help achieve these desirable ends. In fact, in the long run it could well do more harm than good. Essentially, the enactment of this scheme would simply substitute a new tax loophole for the discarded older ones.

If we could believe, with its proponents, that this investment credit crash program could truly spur and sustain economic growth and resolve the balance of payments problem quickly, the AFL–CIO would support it. Unfortunately, these problems will not be ended or even mitigated by this tax windfall, no matter how well intended.

In determining what should and should not be done to come to grips realistically with our economic growth and balance-of-payments problems, a number of widespread falacies need to be exposed. Toward this end, the following questions must be raised as this committee weighs the merits of the investment credit proposal and they should be reasonably answered.

(1) It is indeed true that American industry is substantially obsolete and therefore is being outcompeted in the markets of the world?

(2) It is true that American business needs the tax credit to help finance new investments because otherwise funds would not be available?

(3) To what extent would the tax actually stimulate new capital outlays in enterprises vital to our national goals? To what extent would the tax credit simply subsidize investment that would occurs without it?

(4) With much of our productive capacity still idle because of lagging domestic demand, how long could the spur of the tax credit sustain investment growth? Should not a top priority now be given to tax policies that will encourage the higher demand that is the essential underpinning for sustained investment growth?

(5) What fruitful measure should now be pursued to deal with the balance-of-payments deficit?

Are we outcompeted in world markets?

Investment credit enthusiasts have overcapitalized on the alarmist view that a crisis of obsolescence has overtaken the American economy—a view that is not supported by the facts.

In 1962, private business firms are reported to be spending a record $37.2 billion on new plant and equipment, a rate about 8 percent higher than in 1961. Since World War II, as a matter of fact, capital investment in the United States, excluding agriculture, has exceeded $425 billion—an unparalleled record anywhere.

The view that we are being outproduced and outcompeted is largely due to a misunderstanding of the balance-of-international-payments problem. While it is true that the balance of payments has been negative, the balance of trade has been decidedly positive. In 1961, our nonmilitary exports ($20.1 billion) actually exceeded imports ($14.7 billion) by about $5½ billion. Actually, almost all the balance in our favor comes from finished manufactured products.

"In 1961, they amounted to over $10 billion while our imports of manufactured products were only $5 billion," Secretary of Labor Goldberg proudly announced in public testimony 3 weeks ago. Indeed, "our biggest dollar earners are our exports of manufactured products," he added. Surely, this record doesn't indicate that American industry is too obsolete to compete.

While it may be true that some of our enterprises lag technologically for special reasons, and that total new investment would be even higher if domestic demand was growing fast enough to support it, we hardly can be convinced that technological rigor mortis has overtaken the Nation. Too many American workers have been automated out of their jobs or have justifiable reason to fear that they soon will be, for us to have any illusion that our productive system is standing still.

Is a public subsidy needed to finance "private" investment?

There is just no evidence that American business needs an across-the-board tax credit subsidy to help pay for its new investment. Larger capital outlays are not being deterred because of any overall lack of available private investable funds.

On the contrary, savings available for capital formation are substntial. Actully many businesses now finance new plant and equipment solely with their own internally generated funds—money accumulated from retained profits and depreciation set-asides. From 1946 through 1961, American corporations—excluding financial institutions—invested $374 billion in new plant and equipment. However, their internally generated funds available for new investment over the 15-year period actually totaled 96 percent of that sum. In 1961, this internal cash flow actually exceeded last year's total outlay for new plant and equipment by 6 percent.

In recent years the cash available for investment from depreciation set-asides alone has grown spectacularly. This is due both to the tremendous aggregate rise in postwar investment and the liberalization of depreciation allowances in 1954 and 1958. While in 1953 corporate depreciation allowances totaled less than $12 billion, equal to only 49 percent of capital outlays that year, in 1961 these set-asides reached a staggering total of more than $24 billion, a sum equal to 80 percent of all corporate new plant and equipment expenditure last year. And, with the further liberalization of schedule F now being put into effect by the Treasury, depreciation set-asides will grow even faster.

According to the Council of Economic Advisers, about two-thirds of our manufacturing exports are accounted for by the metal, machinery, and transport industries. Yet, it is precisely the major companies in these industries that are most generously endowed with internally generated funds available for capital improvements. In fact, in recent years they have seldom been forced to sell stock or borrow to meet their new investment needs.

It should also be recalled that the substantial effort to encourage business investment through tax aids has not been confined to liberalized depreciation allowances alone. In 1954, the Congress for the first time also sanctioned the writeoff of research and development outlays as a current cost of doing business. Although this tax law change has also resulted in a substantial Federal revenue loss, it, too, serves as a substantial stimulant to technological process. In 1960, the U.S. outlay for research and equipment by our industries reached a record $10.5 billion compared with less than $2 billion for all the Common Market nations combined.

It is our view that the Congress has already been more than generous in its effort to spur new investment via tax law. In the fact of the ample resources available to business for new plant and equipment, a further across-the-board public subsidy clearly cannot be justified on the basis of overall need.

CAN THE CREDIT ASSURE INVESTMENT THAT SERVES ESSENTIAL NATIONAL NEEDS AND THAT WOULDN'T OCCUR WITHOUT IT?

America's productive plant is neither obsolete, outcompeted nor do businessmen lack access to funds for its expansion. We are told, nonetheless, that the investment tax credit is vitally needed. Moreover, the administration is seeking this generous across-the-board business subsidy not just for a year or two; it is being urged "as a continuing part of our tax structure." According to some estimates the original credit proposal would have cost the Treasury more than $26 billion over the next 10 years.

Will this mountainous giveaway advance the national interest in any relation to its tremendous cost?

Actually, it isn't likely that much additional investment will result from this public outlay that wouldn't occur without it.

While the President's original tax credit proposal was at least aimed at rewarding increased investment from year to year, the House enacted bill now proposes to give this handout to a business even when its new investment is not rising—in fact, even when it is going down. What is more, the committee has lengthened the list of investment credit free riders thereby adding hundreds of millions of dollars to the Treasury's annual revenue loss. Furthermore, as the new equipment (paid for by the public through the subsidy device) wears out, the committee would allow full depreciation set-asides against it. Thus, the benefit from each of these freeloading investment credit handouts would go on and on in perpetuity.

While the tax credit will scarcely assure much added investment that wouldn't occur without it, its payout in tax savings to business will delight the beneficiaries. For example, had it been on the books from 1957 through 1960, Ford and General Motors together would have enjoyed nearly $100 million more in profits after tax.

According to a recent Wall Street Journal survey of business intentions, if the tax credit becomes law, spokesmen for 67 companies out of 68 said it would have no significant effect on their investment plans. As one business leader put it: "This program won't alter our construction program one bit; it's nothing more than a windfall."

According to J. A. Livingston, the popular business columnist, the whole tax investment credit idea is "just another loophole."

Despite its multibillion-dollar cost, most of the tax credit subsidy would also be of dubious value in achieving vital national objectives. It would reward investors in a host of undertakings—from bowling alleys to barber shops—that have little bearing on our ability to raise exports or on other priority national goals. Even new investment in agriculture will be rewarded despite the fact that this industry now receives a vast public subsidy precisely because it is already producing too much. In a similarly generous spirit utilities are included too, although they enjoy a guaranteed rate of profit and already are legally obligated to provide the new investment required to meet expansion needs.

Actually, the major beneficiaries of the billions of dollars about to be squandered under the investment tax credit scheme will be the 500 largest and richest industrial giants of America. These are the enterprises that, according to Fortune magazine, now account for more than half of all our manufacturing and mining production and profits. They account for the lion's share of investment in new plant and equipment as well.

Thus, it is evident that the tax credit would neither guarantee a significant net addition to private investment nor would it selectively stimulate these forms of capital outlay that most serve the Nation's needs. Furthermore, over the years it would impose a burden of billions upon the public for subsidies totally unrelated to the financial need of the business beneficiaries.

Can the tax credit assure sustainable investment growth?

Let us now briefly consider the proposed investment credit against the broader backdrop of the Nation's growth needs.

Enactment of the credit might temporarily nudge business investment higher, but it certainly will not encourage balanced and sustainable economic growth. On the contrary, it would more likely distort the recovery and hasten the next recession just as the overgenerous tax benefits for investors after 1954 temporarily stimulated investment from 1955 to 1957 while consumption lagged. Inevitably, the recession of 1957–58 and a substantial accumulation of unused plant and equipment ensued. Today the tax credit stimulus could be expected to be less because of excess productive capacity already in existence. The artificially continued investment stimulus would be short lived.

The major prerequisite for increased and sustained business investment is high-level use of existing plant and equipment and the expectation that sales will continue to rise. When demand and sales are high and give promise of being sustained, American businessmen generally need little prodding to expand their productive facilities. And even when demand is sluggish, they seem ready enough to improve the efficiency of their capital stock in order to reduce unit production costs.

Today, with substantial American productive capacity still idle, demand must catch up to insure a sustainable investment rise. Since domestic sales are the major support of most of our companies that also export overseas, rising demands

in our home market coupled with a more strenuous effort to sell abroad are now needed to set the stage for a durable investment boom.

Even the most generous investment credit handout cannot stimulate private investment for long in the absence of adequately rising demand.

The findings of the Wall Street Journal's survey support this conclusion completely. It found many concerns are now worried "by excess capacity, which makes spending large sums of money for new machinery seem to them a dubious proposition regardless of tax laws." As one business executive put it, "the problem now is trying to find markets for our present production, not getting money to make more."

With much of our already existing productive capacity still idle for lack of orders, further tax benefits for business should be given the lowest priority. For this reason, and the additional fact that the productivity of new capital investment constantly is rising and multiplying the potential output of goods and services which must be sold, highest priority today should be given to tax policies which broadly stimulate consumer demand.

The kind of spur business needs most is the durable stimulus of rising family spendable income, which lower income taxes for the middle and lower brackets could now help provide. Instead of squandering the revenue from loophole closing on an unwarranted tax credit scheme, it would be far wiser to use it to cut personal taxes and raise consumer demand.

Last spring, when spokesmen for American business were testifying before the Ways and Means Committee, they appeared to be cool to the investment tax credit plan. We assume that this was not due to any desire to reject this lush multi-billion-dollar bonanza out of hand, but rather because they preferred to bargain with the Federal Government for a further increase in depreciation allowances, which they cherish even more.

Depreciation set-asides are entered on the books as a cost of doing business; when depreciation allowances are liberalized, after-tax profits are held down. The investment credit, on the other hand, would have the effect of raising profits after tax. In this form, windfalls are more visible and can be embarrassing. What is more, because faster depreciation writeoffs raise bookkeeping production costs, they invite price markups. A tax credit, however, prevents price distortion.

Although depreciation benefits already have been liberalized twice, in 1954 and 1958, the Treasury recently announced that it is increasing them still further through an overall downward revision of its "useful life" Bulletin F schedule of depreciable business assets. It is estimated that this administrative adjustment alone will increase depreciation set-asides by about $1½ billion annually. In our view, the actual useful life of a business asset is the proper depreciation rate yardstick—no more and no less. If inequities exist under the old Bulletin F schedule, because of an accelerating rate of capital replacement, the AFL-CIO supports their removal.

Having won their faster depreciation writeoff victory over at the Treasury, however, the business community apparently decided to seek a second victory by substituting a still faster depreciation writeoff scheme in lieu of the administration's tax credit proposal. Until hours before the House vote this was the Republican plan, and it was finally abandoned only for reasons of political expediency.

However, whether the additional $1.2 billion business tax benefit had been gained via the investment credit or the still faster depreciation writeoff route, in our view makes little difference. Either way, the deck is loaded against the average taxpaying family and the national interest.

How should we resolve the balance-of-payments problem?

If the investment credit is not the way to meet the balance-of-payments deficit, then how do we effectively cope with this continuing national problem?

According to a report of Secretary of the Treasury Dillon a week ago, the basic dollar deficit of the United States as a consequence of all our transactions with foreigners except the international ebb and flow of short-term capital, was $600 million in 1961. This was a very substantial reduction from the basic deficit of $1.9 billion in 1960 and $4.3 billion in 1959. The growth of our trade surplus from $1 billion in 1959 to $4.7 billion in 1960 and $5.5 billion in 1961 largely accounts for this reduction.

As long as governments continue to settle their international transactions by a transfer of the world's limited supply of gold, countries with adverse balances and too little gold are faced with trouble. For this reason, the United

States, with its postwar hoard of gold, has taken drastic and generous steps to help other nations that have, or had, too little. Now that postwar reconstruction and prosperity have been achieved by many nations, some now find themselves in possession of a growing accumulation of gold and dollars. On the other hand, in recent years America's international accounts have gotten out of balance and our gold loss has been substantial. Steps to rectify this situation are clearly necessary.

There are many things that can be done.

In the first place, the administration's effort to insure greater opportunities for the sale of U.S. products in world trade through tariff reduction, must be supported.

Second, it is imperative that other prospering nations that enjoyed our generosity during the postwar years now shoulder a larger share of the rising cost of economic and military aid and of maintaining international institutions.

What is more, we must now institute a system of offshore procurement in reverse. Just as a few years ago we wisely built up the dollar earnings of other nations by buying military and other supplies from them, other countries now must be encouraged to buy from us, particularly those who are directly receiving or indirectly benefiting from our aid.

In addition, special inducements to export American capital due to the unwarranted and outdated preferential tax treatment we still accord income earned abroad, must now be ended as requested by the President. The bill before you goes only part of the way in closing these loopholes. Completing the job, as we will point out later, will reduce the balance-of-payments deficit and recoup $250 million in needed revenue for the Treasury.

If further drastic steps are needed—and other countries have not hesitated to use them when confronted by a payments crisis—the movement of private capital abroad should be restricted and directed in accordance with priority national needs. Moreover, the travel outlays of Americans abroad could be further limited, temporarily. Under any circumstance, a far more vigorous effort to encourage foreign tourists to visit and spend in the United States must now be undertaken.

A combination of some or all of these measures will end the balance-of-payments problem. Although the administration is already pushing some of them. a greater effort is needed.

Finally, we should also strive to raise our export surplus still further, although there must be a realistic limit to our expectations. The economic resurgence of other countries and the reduction of tariff barriers amongst them are inevitably creating sharper competition for America. It is well to recall that the era in which our industries alone remained unscathed by the devastation of war has receded far into history. What is more, many nations must, indeed, "export or die"; in our zeal to sell abroad we must not undermine the economies of our friends.

However, instead of rushing to enact the blunderbuss investment credit scheme in the name of spurring exports—which would only distort economic growth at home and impose an unjustifiable and costly burden on the taxpayer—we should be shaping wiser and less expensive policies to spur sales overseas.

American businessmen themselves should work harder to sell to potential customers abroad and to compete more effectively at home against imports as well. As a dramatic example of this need, it is important to recall the costly failure of the automobile industry to anticipate the growing domestic and foreign preference for compact cars. As a consequence, our loss of sales and of dollar exchange in both areas was tremendous. Although foreign trade has been vitally important to a few American industries, exports still account for less than 5 percent of the sale of America's total national product. For this reason, export potentialities have not been a major preoccupation of the business community or even of the Federal Government, until recently. The balance-of-payments problem clearly requires a change of view.

What is more, money now being sought for the wasteful investment tax credit should be selectively used and be limited to the creation of a variety of aids that specifically encourage a favorable U.S. balance of trade.

While international agreements should properly prohibit aids that lead to the dumping of goods overseas, much can be done—and now is being done by other governments—to legitimately stimulate exports.

In the first place, if an investment tax credit has validity it should be restricted to enterprises engaged in production for export or in strenuous competition with imports.

Secondly, the granting of one or another form of direct tax concession related specifically to levels of export sales, might well be explored by this committee. However, such tax benefits, including investment credits, should be allowed only temporarily, for as long as our balance-of-payments deficit continues.

Furthermore, low-cost credit for loans for overseas customers and low-cost insurance to cover the commercial and political risks associated with foreign sales, must be made more widely available. Toward this end, the actvities of the Export-Import Bank must be increased.

In our view, this committee would perform a great service by thoroughly studying the feasibility of these and all other export stimulating alternatives. We are advised that as long as these devices do not result in lower selling prices abroad than in our own domestic market, they are not barred by any international pact.

We are convinced that wise that wise selection from among many constructive available means of attacking the balance-of-payments problem—short of resorting to the costly and unwarranted across-the-board investment credit—will bring results.

CLOSING TAX LOOPHOLES

Tax withholding on dividend and interest income

One of the important features of the bill before you is that it will withhold dividend and interest income for tax purposes, in accordance with the President's request.

This proposal imposes no new tax; it simply would enforce payment of what has long been due.

Gross discrimination now exists between wage and salary income and dividend and interest income because withholding applies to one and not the other.

The withholding system leaves no room for the forgetful, the neglectful, or those who would deliberately try to avoid payment of taxes. Uncle Sam receives his due share of wage income almost at the same time that the wages are paid to the worker.

As a result of withholding, 97 percent of all wage and salary income is reported on Federal income tax returns. Because no withholding system applies to dividends, to interest, or to any other type of income, a far larger proportion of this income is not reported in income tax returns. Treasury data shows that for 1959, 9 percent of all dividends and 35 percent of all interest remained unreported. It is estimated that the total of unreported income in these two categories amount to $3.8 billion.

A long as the withholding system applies only to wages and salaries, a gross injustice exists which forces wage and salary income to pay a greater share of the tax burden than other types of income. Clearly the answer is to equalize this treatment by instituting a withholding system on other types of income.

What have been the objections to this proposal? Some of those who regularly pay dividends and interest to holders of their securities have insisted that a withholding system would be too great an administrative burden for them to bear. However, it would be far less than the burden they now assume in withholding income taxes from wages and salaries. Moreover, in the past few years, many firms have introduced mechanical operations into their dividend and interest payment procedures so that whatever additional bookkeeping in involved can be swiftly handled.

Another objection has been a concern that many low-income recipients not subject to tax would find their dividend and interest payments reduced by the amount of the withholding, and be forced to undergo personal hardship while awaiting refunds from the Treasury.

This is a problem of but minor proportion.

In the first place, Treasury figures reveal that only 11 percent of unreported dividends, and 29 percent of unreported interest is received by taxpayers with incomes below $5,000. The great bulk of it belongs to those with higher incomes.

What is more, for those with low incomes the bill before you provides for an equitable arrangement whereby individuals who expect no tax liability can avoid withholding, as can all individuals under 18. Besides, married couples with less than $10,000 income and individuals with less than $5,000 can receive quarterly refunds if they expect to have less tax liability for the year than the amount withheld.

We cannot endorse too strongly this section of the bill before you. Its enactment will restore $650 million in sorely needed funds to the Treasury and immeasurably restore confidence in the fairness of the Federal tax system. We hope that the adoption of this proposal will win swift approval from the committee.

Repeal the dividend credit and exclusion

A year ago President Kennedy in his tax message urged the Congress to repeal the inequitable dividend credit and exclusion in its present tax bill. A credit for unearned income creates a glaring inequity in the Federal tax system, he pointed out. The failure of the bill now before you to deal with this issue is a grave omission and should be rectified.

The dividend credit and exclusion was passed by the Congress in 1954. At that time, both the AFL and the CIO, as separate organizations, strongly opposed this proposal. Nothing that has happened since has led us to change our opinion that the adoption of this proposal by the Congress has resulted in favorable treatment to one class of income receivers at the expense of all others.

We fully recognize that dividends play an important role in the American economy: they are the essential means of providing a return to the owners of equities in American industry. The issue before this committee, however, is not whether dividends are good or bad but how dividends should be taxed. In brief, it is our judgment that all sources of income, whether from wages, rents, dividends, or interest, should be treated alike under tax law.

Currently the law allows taxpayers with dividend income two special benefits:

1. A taxpayer may exclude from his income up to $50 of dividend income ($100 for married couples), and
2. He is entitled to deduct from his tax an amount equivalent to 4 percent of all dividends received above the exclusion.

Who receives this $450 million in special benefits?

A study by the highly respected University of Michigan Survey Research Center shows that in late 1959 to early 1960 only 14 percent of American families owned any stock whatsoever in publicly held corporations. The proportion was far higher for families headed by a professional person or company official, but only 8 percent for families headed by a craftsman and only 2 percent for families headed by laborers or service workers.

Ownership of but a few shares of stock is of small value in making use of the preferential tax treatment for dividend income. The Michigan study makes clear the fact that the average stockholding by low- and moderate-income families is small, while the larger holdings are concentrated in families with incomes of $10,000 and over. In fact, it is estimated that less than 6 percent of all families (all stockholder families with over $10,000 income) own 64 percent of the value of all stock. The accompanying table provides more information on stockholding by income level.

Concentration of publicly traded shareholders in various income groups

Income	Percent distribution of families	Percent owning stocks in each group	As percent of all families	Percent distribution of total value shareholders
Under $5,000	46.7	5.8	2.6	10
$5,000 to $9,999	39.0	15.9	6.0	26
$10,000 to $14,999	9.8	35.5	3.2	22
$15,000 and over	4.5	55.4	2.5	42
Total	100.0	14.3	14.3	100

Source: Survey Research Center, University of Michigan, "Stock Ownership Among American Families," June 1960, table 2, mimeographed.

As the table makes clear, only 5.8 percent of families with incomes under $5,000 own stock. This percentage increases with each higher level of income until for families with incomes over $15,000, the proportion owning stock is 55.4 percent.

Another source of information on dividend recipients is the income tax returns. Secretary Dillon's statement before the House Ways and Means Committee provided basis statistics from this source showing the distribution of dividends re-

ported on income tax returns (exhibit IV, table I). We include these statistics in table I.

This table provides information by individual income tax return rather than by family income. The data present a picture similar to that of the University of Michigan material. The proportion of income tax returns reporting dividend income rises with total income. For taxable returns with income under $5,000 only 6.4 percent reported dividend income. (See col. 6.) For returns with income between $5,000 and $10,000, the proportion is only 9.7 percent. However, for those with income from $50,000 to $100,000, the proportion is 88 percent, but rises to 92 to 97 for incomes over $100,000.

The same trend is evident if we examine the amount of dividends as a percent of adjusted gross income. The proportion of dividends reported on taxable returns of under $5,000 and in the $5,000 to $10,000 bracket is only 1 percent. (See col. 7.) For those with incomes from $50,000 to $100,000 it is 22 percent, but in the higher brackets, it ranges from 32 to 52 percent.

We include as tables II and III basic data relating first to the dividend exclusion, and second to the dividend tax credit. The table pertaining to the dividend exclusion shows that 8 percent of all returns claimed the exclusion in 1958, and the average amount of dividends exclusion on each return was $64.09. However, for taxable returns under $5,000 only 4 percent claimed the exclusion, with an average amount of $53.16. At the other end of the income scale, over the $50,000 level, 89 percent claimed the exclusion and the average amount excluded had risen to $84.57.

Table IV provides basic statistics regarding the distribution of dividend tax credits in 1958. The number of returns claiming the tax credit represented about 5 percent of the total. But for those taxable returns with incomes under $5,000, the percentage was only 2.7 percent. Moreover, the average tax credit granted for these returns was only $24. The proportion of the returns with tax credit and the amount of that credit rises steadily with increases in income. For taxable returns with income over $50,000, 69 percent claimed the credit and the average tax saved amounted to $1,035. At the highest level of income returns on $1 million or more, the average tax saved was over $30,000 per return.

In summary, it is clear that not only the dividends themselves but the tax benefits in the form of the exclusions and credits are all highly concentrated in the upper income brackets. While the taxable returns with income under $5,000 include 41 percent of all the returns, they only include 20.5 percent of all returns with dividends, 7 percent of all dividends reported, and only 5.5 percent of the total dividend tax credits (tables III and IV). On the other hand, returns with incomes over $50,000 include only about two-tenths of 1 percent of all the returns, but these include 33 percent of all dividends and 36 percent of the total dividend tax credits.

In view of the highly inequitable nature of these tax benefits, can they be justified on any grounds? We have examined very closely the arguments of the supporters of the dividend credit and exclusion, and we feel most strongly that they are without merit.

The chief argument advanced for special treatment of dividend income is that this income is taxed twice—once by the corporation tax while it is still in the hands of the corporation, and the second time by the income tax when it is distributed to the stockholder. This argument just doesn't stand up.

1. All families face many kinds of double taxation. For example, a worker who pays income tax on his earnings and then uses what is left to buy a car on which he pays a Federal excise tax, is paying a double tax. But he gets no special treatment. Similarly, because of the multiplicity of Federal, State, and local taxes, millions of Americans pay double, triple, and even quadruple taxes on the receipt and expenditure of the same income.

2. It is by no means certain that business actually bears the weight of the corporation tax; often it is merely shifted to consumers in the form of higher prices or to employees in the form of lower wages. According to Dr. Emerson P. Schmidt, chief economist for the Chamber of Commerce of the United States, and, presumably, particularly informed in this area, "taxes on business are essentially taxes not on the stockholder but on the consumer." [1]

3. Even if there was conclusive evidence—and there is not—that dividends suffer from double taxation and exclusively bear the brunt of multiple taxation,

[1] Address on "Prices and Costs," West Virginia University Labor-Management Conference, Apr. 20–21, 1961.

the dividend exclusion and credit provision of the present law is a highly unfair remedy. Its present effect is to substantially reduce so-called double taxation in the very top brackets while hardly affecting it in the lower brackets.

Secretary Dillon has demonstrated this conclusively by showing how the operation of the present system relieves only 7 percent of the extra burden caused by so-called double taxation of dividends in the lower brackets, but 35 to 40 percent and higher in the higher income brackets (testimony before the House Ways and Means Committee, exhibit IV, table 8).

In the light of this evidence, there is no justification whatsoever for retaining the present system. There may be some who will argue that the tax credit should be abolished but the dividend exclusion retained. We see no justification for this position. Although the exclusion costs the Treasury only about one-third of the revenue lost by the credit, it is no less inequitable. No other source of income is given a special exclusion. Taxation of wage income starts with the first dollar and there is no logic for any different system for any other type of income.

There never has been any economic justification for granting dividend income any favorable treatment under the tax laws. The action Congress took in 1954 has been nothing more than a bonanza for the high income taxpayers.

We therefore strongly urge this committee to follow the President's recommendation by abolishing both the credit and the exclusion.

TABLE I.—*Number of individual income tax returns with dividends and amount of such dividends in 1958*

[Dollar amounts in thousands]

Adjusted gross income	Number of returns with dividends [1]	Dividends on returns [1]	All returns	Adjusted gross income, all returns	Number of returns with dividends as a percent of all returns	Dividends on returns as a percent of adjusted gross income
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Taxable returns:						
Under $5,000	1,053,591	$646,428	24,129,298	$74,263,196	6.4	0.9
$5,000 to $10,000	1,724,929	1,201,103	17,702,182	120,222,881	9.7	1.0
$10,000 to $20,000	1,109,027	1,648,580	3,073,449	39,218,752	36.1	4.2
$20,000 to $50,000	439,837	2,055,025	634,002	18,189,272	69.4	11.3
$50,000 to $100,000	80,701	1,328,065	91,605	6,042,852	88.1	22.0
$100,000 to $200,000	16,453	747,995	17,894	2,302,842	92.0	32.5
$200,000 to $500,000	3,792	483,445	3,934	1,109,680	96.4	43.6
$500,000 to $1,000,000	515	171,000	531	356,220	97.0	48.0
$1,000,000 and over	227	252,739	236	482,640	96.2	52.4
Nontaxable returns	696,741	522,486	13,433,048	18,965,757	5.2	2.8
Total	5,125,813	9,057,766	59,085,182	281,154,092	8.7	3.2

[1] Covers domestic and foreign dividends before dividend exclusions. Does not include data for form 1040A returns which do not specify the amount of dividends received.

Source: Treasury Department, Office of Tax Analysis.

TABLE II.—*Dividend exclusions, 1958*

Adjusted gross income	Total number of returns	Returns with exclusions		Total amount excluded		Amount of exclusion per return with exclusion
		Number	As percent of total returns in each gross income class ((3)÷(2))	Total (thousands)	Percent distribution	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Taxable returns:						
Under $5,000	24,129,298	1,007,774	4.2	$53,570	16.9	$53.16
$5,000 to $10,000	17,702,182	1,665,331	9.4	103,451	32.6	62.12
$10,000 to $20,000	3,072,449	1,089,201	35.5	78,216	24.7	71.81
$20,000 to $50,000	634,002	435,193	68.6	34,503	10.9	79.49
Over $50,000	114,200	101,252	88.7	8,563	2.7	84.57
$50,000 to $100,000	91,605	80,312	87.7	6,752	2.1	84.07
$100,000 to $200,000	17,894	16,420	91.8	1,427	.4	86.91
$200,000 to $500,000	3,934	3,781	96.1	325	.1	85.96
$500,000 to $1,000,000	531	512	96.4	42	(1)	82.03
$1,000,000 and over	236	227	96.2	17	(1)	74.89
Nontaxable returns	13,433,048	648,966	4.8	38,811	12.2	59.80
Total	59,085,182	4,947,717	8.4	317,204	100.0	64.09

[1] Less than 0.05 percent.

Source: "Statistics of Income, 1958."

TABLE III.—*Dividend tax credits, 1958*

Adjusted gross income	Total number of returns	Returns with tax credits		Total amount of tax credits		Amount of tax credit per return with credit
		Number	As percent of total returns in each gross income class ((3)÷(2))	Total (thousands)	Percent distribution	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Taxable returns:						
Under $5,000	24,129,298	647,249	2.7	$15,685	5.5	$24
$5,000 to $10,000	17,702,182	999,851	5.6	35,918	12.5	36
$10,000 to $20,000	3,072,449	782,862	25.5	55,954	19.5	71
$20,000 to $50,000	634,002	387,773	61.2	74,037	25.9	191
Over $50,000	114,200	78,702	68.9	102,163	35.7	1,035
$50,000 to $100,000	91,605	77,970	85.1	47,986	16.8	615
$100,000 to $200,000	17,894	16,227	90.7	26,095	9.1	1,608
$200,000 to $500,000	3,934	3,770	95.8	15,956	5.6	4,232
$500,000 to $1,000,000	531	508	95.7	5,154	1.8	10,146
$1,000,000 and over	236	227	96.2	6,972	2.4	30,714
Nontaxable returns	13,433,048	103,124	.1	2,616	.9	25
Total	59,085,182	3,019,561	5.1	286,373	100.0	95

Source: "Statistics of Income, 1958."

TABLE IV.—*Percent distribution of tax returns and dividends, 1958*

Adjusted gross income (1)	Total number of returns (2)	Number of returns with dividends (3)	Total amount of dividends (4)
Taxable returns:			
Under $5,000	40.8	20.5	7.1
$5,000 to $10,000	30.0	33.6	13.3
$10,000 to $20,000	5.2	21.6	18.2
$20,000 to $50,000	1.1	8.6	22.7
Over $50,000	.2	2.0	32.9
$50,000 to $100,000	.2	1.6	14.7
$100,000 to $200,000	(1)	.3	8.3
$200,000 to $500,000	(1)	.1	5.3
$500,000 to $1,000,000	(1)	(1)	1.9
$1,000,000 and over	(1)	(1)	2.8
Nontaxable returns	22.7	13.6	5.8
Total	100.0	100.0	100.0

[1] Less than 0.05 percent.

Source: "Statistics of Income, 1958."

End of capital gains treatment on sale of depreciable assets should include real estate

Almost a year ago the President stated that "another flaw which should be corrected at this time relates to the taxation of goods on the sale of depreciable business property. Such gains are now taxed at the preferred rate applicable to capital gains even though they represent ordinary income."

The President specifically asked that this tax change should apply to real estate as well as other kinds of business assets.

Profiteering from the sale of depreciable assets has been greatly encouraged by the acceleration of depreciable property by the Congress in 1954 and 1958, which now allow as much as 65 to 70 percent of the value of an asset to be written off in the first half of its useful life.

These more liberal depreciation rules have created a critical issue for tax policy whenever a taxpayer sells a depreciated asset for an amount greater than its depreciated value.

This issue can best be illustrated by a specific example: Assume that a business asset with a life of 10 years was purchased for $100 and has been depreciated $65 by the end of the first 5 years. On the books of the company, therefore, this asset is valued at $34. The occasion now arises when the company wishes to sell this asset. In so doing, it finds that the actual market value of the asset is $50. The tax issue involved in this example is as follows: How should this $15 difference between the actual market value and the depreciated book value of the asset be taxed?

Currently, this difference is taxed as a capital gain. The maximum tax rate for capital gains is 25 percent of the total gain.

It is evident that the present tax law allows a taxpayer to obtain double benefits from depreciation allowances. The taxpayer can first obtain a deduction from his income by claiming depreciation. Under the 1954 law, Congress has been most generous in allowing accelerated types of depreciation. Secondly, when the specific piece of property is sold, the large depreciation allowance now becomes an additional advantage because the profit realized from the sale of this equipment can be classified as a capital gain rather than as ordinary income.

Obviously the way becomes open for taxpayers to manipulate their purchases and sales of business assets (real estate and capital equipment) not to meet legitimate economic needs of business, but rather to obtain special tax advantages allowed by the present tax laws.

We should like the committee to particularly note that this problem is becoming more acute with the passage of time. The more liberalized depreciation allowances enacted in 1954 and the depreciation assistance granted to small business in 1958, all make it possible for taxpayers to depreciate property and equipment more rapidly than in the past. The result is that many assets are being carried on the books at prices well below their true market value. With

each passing year, and now, particularly with the current downward revision by the Treasury of "useful life" schedule under Bulletin F, the gap between the market value and the depreciated value of these business assets becomes larger.

The bill before you recognizes the nature of this problem and sets out to meet it by eliminating this kind of profiteering under the tax law. However, the area in which profiteering is greatest as a result of the present tax loophole is made exempt under the terms of the bill now before you. We refer to real estate.

A year ago when Secretary Dillon testified before the House Ways and Means Committee, he referred particularly to the Treasury's desire to "eliminate this kind of tax trafficking" in real estate sales. He pointed out that much of the tax advantage in the present law is attached to "investment in so-called depreciation shelters which exist primarily in the real estate area." The way in which real estate profiteers operate under the generous provisions of the present law was dramatically told by the Secretary in these words:

"* * * During the first few years after acquisition of a building by a real estate syndicate, the total depreciation allowances and mortgage interest will often exceed the rental income, so that distributions of income during this period are tax exempt in the hands of the investor. When the distributions substantially cease to be tax exempt, the building is sold, a capital gains tax paid on the gain attributable to the depreciation allowances, and another building is acquired to provide another depreciation shelter. Withdrawal of capital-gain treatment from the gain on sale of the building, to the extent of prior depreciation allowances, will substantially eliminate this kind of tax trafficking."

It is our view and we hope that this committee will concur that corrective action should apply across-the-board to all types of depreciable assets. This should apply to real estate as well as personal property because manipulation to take advantage of the loophole in the present tax law has been particularly widespread.

Under the proposal now before you, which allows tax profiteering on the sale of real estate to continue unchecked, only $100 million annually will be recouped by the Treasury. By returning to the original proposal of the administration, it is estimated the revenue gain will be doubled.

End expense account abuses

In asking for certain immediate tax reforms a year ago, the President said:

"Expense account living has become a byword on the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

The bill before you takes several commendable steps toward ending the shocking expense account racket. But it doesn't go far enough.

The bill properly would now require that all claims for deductible expenses be substantiated by adequate records covering the amounts and circumstances of expenditure. In addition, outlays for entertainment, amusement and recreation would be disallowed unless it is established that they are directly related to the active conduct of a trade or business. Also the cost of a facility used for business entertainment, such as a yacht, would only be deductible if it is used more than half the time for business purposes. Deduction for business gifts would be limited to $25 per recipient per year.

The proposals of the President are more stringent.

He asks that deductible food and lodging expenses during business trips be limited to twice the maximum allowed for Federal employees (this would be $32 per day).

He asks that deduction for club dues and fees for social, athletic and sporting clubs be disallowed.

He asks that so-called business gifts be disallowed to the extent that they exceed $10 per recipient per year.

He asks the virtual elimination of deduction for expenses incurred in entertaining guests at night clubs, theaters, country clubs, prize fights, on hunting and yachting trips, and the like.

Whereas the House bill would yield the Treasury an estimated $135 million in revenue, the President's proposal will yield at least $250 million per year.

We support the President's proposals. The greatest defect in the bill before you is its failure to require proof that each deductible item is directly related to the production of business income. Furthermore, its failure to specifically

disallow outlays incurred simply to creat "good will" perpetuates the mile-wide loophole by means of which millions of dollars of extravagant personal expenditure is now being pawned off as a business expense. Moreover, deductions for certain categories of entertainment—like theaters, nightclubs, and sporting events—surely should be disallowed as not conducive to specific business discussions. What is more, a specific reasonable ceiling on per diem travel costs, and a lower ceiling for gifts, should now be established.

Quite another aspect of the effort to end expense account abuses has been raised by those who arge that upsetting the status quo will adversely affect their livelihoods. Managements in the related enterprises and unions have spoken out vigorously about this aspect.

It is the viewpoint of the AFL–CIO that the essential responsibility of those who write our tax laws, besides meeting revenue needs, is to seek to achieve an absolute sense of equity.

In this spirit the AFL–CIO has long fought to end excise taxes which have singled out the entertainment industry for punitive treatment. In the same spirit we must support the end of tax rackets which accrue to specially favored individuals at the expense of everyone else.

While it is possible that ending expense account abuses may have a short-run adverse effect upon some segments of the entertainment industry, it should be noted that:

(1) Only by closing tax loopholes can the illegitimate advantages of a few be converted into overall tax reduction opportunities for the many, with its consequent likelihood of greater outlays by millions of families for entertainment and other purposes.

(2) If public subsidies for various aspects of entertainment are to be provided by Government—and many voices have been raised in support of them—they should be provided directly and not by a tax subterfuge which unjustifiably rewards a few privileged patrons at the expense of the rest of the American people.

For all these reasons, the AFL–CIO urges this committee to further pursue commendable efforts to finally eradicate the expense account racket from the tax system of the United States.

Deducting lobbying expenses

The proposal on this matter in the bill before you (sec. 3) is in the nature of loophole opening rather than closing. We oppose it for both substantive and procedural reasons.

The bill would add a new subsection (sec. 162(c)) to the provision of present law which would make deductible as a legitimate business expense certain types of outlays for lobbing activity—Federal, State, and local.

While it is presumed that this deduction would apply only to legislative activities directly related to the conduct of a specific business, the bill would surely open wide the floodgates.

Every corporation in the country, for example, could well seek to have the public underwrite its lobbying efforts to lower its income taxes, on the ground that tax rates affect specific businesses. It could be argued, as well, that the costs of lobbying for lower Federal expenditures should be deductible, on the theory that this would mean lower taxes. Quite plainly, under this proposal, automobile manufacturers could make a case for the deduction of their expenses for lobbying for increased tariffs on foreign cars, on increased highway building programs, or against measures to curtain noxious exhaust gases, etc. While there is no lack of corporate lobbying at present, lobbying outlays can be expected to increase enormously, if they could be openly deducted.

Moreover, in a letter dated February 26, 1960, from the Treasury to the House Ways and Means Committee, it is suggested that many lobbying expenses are already being deducted under the guise of advertising, promotion, legal, and like expenditures. The committee report on H.R. 10650, concedes "the difficulty in segregating and classifying such expenses."

Presumably, the way to resolve this segregation problem, according to the bill before you, is to open wide the floodgates by simply making deduction of lobbying expenses legal.

What is more, in proposing that the public now underwrite business lobbying expenditures by changing the Revenue Code, it is noteworthy that no proposal is currently being made to allow a similar tax-deduction privilege to individuals seeking to influence legislative decisions. If the issue of freedom of speech is, indeed, at stake, surely lobbying engaged in out of altruistic motives should be

treated as favorably as business enterprises seeking to promote their own self-interest.

It should be noted also that the Treasury letter already referred to further states that, "General reversal of policy relating to the deductibility of legislative activities can result in considerable decrease in revenues. * * *" If only because of the still loose provisions covering business expense deductions contained in the present bill—particularly for entertainment to encourage good will—we are certain that the revenue loss will, indeed, be substantial.

Quite apart from its content, it is also noteworthy that the issue covered by section 3 was not included in the President's tax message of April 1961, nor was public testimony on it invited by the Ways and Means Committee during its hearings.

During the course of House debate last week, the view was logically expressed by an important member of the committee majority that this subject matter has no proper place in this bill.

We are compelled to concur with this view.

Taxing mutual thrift institutions

The crux of the conflict between the commercial banks and the mutual thrift institutions has revolved around the preferential tax treatment long accorded the latter.

As a matter of fact, until 1952 mutual savings banks and savings and loan associations were not required to pay Federal tax on the theory that the money of the members was simply being loaned to themselves. Thereafter, the Congress subjected the mutual savings institutions to the regular corporate income tax, but allowed them a special deduction from income for bad debt reserves which have proved to be so large they remained virtually exempt from tax.

In his tax message a year ago, the President asked the Congress to review this situation and to insure nondiscriminatory treatment.

In 1960, the mutual savings institutions had assets of about $110 billion and their growth in deposits has been building toward $10 billion yearly. At current levels of activity, they are earning almost $1 billion a year, after deductions for interest and dividends to depositors, but before provisions for reserves.

Under the bill now before you, new methods of taxing these institutions are provided. Under the alternative that most generally will be chosen 60 percent of earnings may be set aside as a permissible reserve deduction tax free. The regular corporate tax rate will apply to the remaining 40 percent and the aggregate Federal tax will approximate $200 million. This is equal to a tax of about 20 percent on earnings in contrast to the regular corporate tax rate of 52 percent.

Defenders of a preferential rate for the savings institutions have made much of the greater risks involved in their long-term investment in home mortgages, in contrast to the lesser risks inherent in the short-term loans of commercial banks.

However, it is acknowledged that the reserves of the savings institutions have become very large in relation to their actual risk experience.

Defenders of the savings institutions argue further that any lesser preferential tax treatment than provided by the bill will adversely affect homebuilding. It is answered, on the other hand, that both home buyers and mortgage lenders already are substantially protected by a variety of Federal aids. Besides, deposits in the savings institutions are likewise protected by Federal guarantees.

It is our view that the issue of aid to home construction should be faced directly, with less utilization of the indirect preferential tax device. In fact, the earnings and reserves of many of the mutual savings institutions are now so great—largely due to their special tax treatment—that reserves build up constantly for higher interest payments to depositors. But, this in turn creates a tendency to raise the interest charges imposed on home borrowers, as well.

We urge the committee to carefully reconsider the efficiency of this House proposal. While we recognize the need for an adequate transitional period in adjusting taxes upward when they have been unrealistically low in relation to the burden of others, the factors of changing times and needs and equity can no longer be overlooked.

Taxation of foreign income

Tax deferral and tax havens.—I now turn to another aspect of the bill we consider to be of very great importance. I refer to the provisions dealing with taxation of earnings of foreign subsidiaries of U.S. firms.

Under present tax laws, profits earned by U.S. firms operating through foreign subsidiaries are subject to U.S. tax only when they are returned to the parent company in the form of dividends. This means, at the very least, deferral of tax payment, during which time the U.S. subsidiary operating abroad can retain the income it might otherwise have to pay in taxes. This gives it a tax advantage over American competitors operating at home, especially when, as in most countries, the foreign tax is lower than the comparable U.S. tax. In some cases, it actually encourages indefinite postponement of both repatriation of income earned abroad to the United States and therefore indefinite deferral of U.S. taxes on the income earned abroad.

The present provisions are both inequitable and harmful to our economy. They deny fair treatment by placing U.S. corporations which operate overseas in a privileged position over U.S. businesses operating exclusively within our shores. The tax liability of American firms should be determined solely by the amount of their income and not on where the income is earned.

The present provisions of the law also hurt our national economy by providing an incentive to American businesses to invest overseas rather than at home in order to reap the gains of the tax deferral privilege.

Thus, investment decisions of American firms are influenced in favor of foreign investment not by legitimate economic considerations but on the basis of the tax advantage to be obtained by locating overseas.

The tax advantages enjoyed by U.S. firms operating overseas have helped to stimulate the tremendous amount of foreign investment by American business in recent years. In 1960 with the addition of $5 billion to foreign investment, total holdings abroad of U.S. firms exceeded $50 billion. Although later figures are not yet available, the Commerce Department has reported anticipated increases for 1961 and 1962 at least as large as the 1960 rise.

While U.S. firms have invested in all parts of the world, the bulk of their funds has gone into the industrially advanced prosperous countries of Western Europe. Few American firms have established facilities in the capital-starved less developed countries in Asia, Africa, and Latin America. Moreover, in those areas, U.S. investment has been concentrated in oil and other extractive industries which do not contribute significantly to balanced economic development.

Sales of goods of U.S. manufacturing subsidiaries and branches located overseas in 1960 amounted to nearly $24 billion of which $9.3 billion were from Europe and $8.9 billion from Canada. However, European sales have been growing faster than those from any other area. Overall sales of U.S. foreign operations have been increasing considerably faster than U.S. exports.

U.S. foreign investment has an important impact at home as well as abroad. This impact on production, exports, employment, and wages is often hard to measure because the known results of foreign investment must be compared with what might have happened if such investment had not occurred.

U.S. investment abroad has both a plus and minus effect on U.S. exports and production but the net result is undoubtedly negative. Our best judgment is that $3 to $5 billion a year, and perhaps even more, has been lost in U.S. sales abroad because of the output and sales of American companies operating overseas. In terms of employment, this means some 250,000 to 500,000 jobs have been lost to American workers through migration of American industry abroad. Removal of tax deferral on income earned in developed countries would help retain existing jobs in the United States as well as create new ones by encouraging investment in the United States rather than in Western Europe.

The tax inducement for investment in Western industrialized countries is particularly indefensible in the light of its impact on our balance-of-payments problem. In 1960, three-fourths of direct foreign investment by U.S. corporations was in the European nations and Canada. All of this investment abroad showed up on the minus side of the balance-of-payments ledger.

But this is not all. Although our exports have increased markedly during the past few years, our total export sales could have been still larger had it not been for the $3 to $5 billion a year in sales abroad we have been losing because of the operation of U.S. oversea subsidiaries. If this amount were added to our present exports, we would have more than enough to convert the deficit in our balance of payments to a surplus.

Thus, on every grounds, the continuance of the tax deferral privilege for investment in industrialized countries, while perhaps justified in Marshall plan days, is indefensible in today's world. It is not equitable. It discourages investment at home and in less developed countries where it is needed and encourages it in the prosperous industrialized nations which have no lack of capital. It exports sales and jobs. It aggravates our already difficult balance-of-payments problem. On the basis of every relevant consideration, therefore, the tax deferral privilege should be immediately eliminated for income earned in developed countries.

Tax havens.—The tax-haven device deserves special mention because it represents the most extreme type of abuse of the tax deferral privilege. Hundreds of American corporations have established subsidiaries in tax-haven countries such as Switzerland, Panama, Liechtenstein, Bermuda, the Bahamas, and other countries solely to take advantage of the extremely low corporate income taxes of those countries. The American firms do not produce in the tax-haven countries; they contribute little or nothing to their economies. They merely set up skeleton sales and distribution operations in these low-tax areas through which they funnel their profits, regardless of where they are earned.

Here is the way a typical tax-haven operation works. A U.S. firm, the XYZ corporation, has a foreign subsidiary in country A in which it manufactures products for sale in country A, the United States, and other countries. It sets up a sales subsidiary in Switzerland or some other such tax-haven country for the purpose of funneling its sales and distribution. Technically, therefore, the income on the sale of its products of country A is earned in Switzerland.

The company pays no tax in country A and none in the United States unless and until it repatriates its foreign-earned income to the parent company in the form of dividends. It pays little or no tax in Switzerland, because Swiss taxes are nominal at best.

This is only one example of the way in which U.S. companies operating in tax havens can completely avoid paying any taxes on their oversea income. Many other devices can be used to achieve the same result. Small wonder, then, that U.S. firms are increasingly turning to tax havens to dodge tax payments on income earned overseas.

On April 20, 1961, President Kennedy in his tax message called for elimination of tax deferral privileges in developed countries and of tax-haven deferral privileges in all countries. The President repeated the same request in his state of the Union message of January 11, 1962. The President at no time has altered his original recommendations.

As passed by the House of Representatives, H.R. 10650 goes a long way toward meeting the President's recommendations. The bill makes four important changes in tax policy relating to foreign-earned income:

(1) All income derived from a U.S.-owned sales subsidiary operating abroad would be subject to the full U.S. tax when earned unless the earnings were reinvested in a less developed country.

(2) All income derived from a U.S.-owned production subsidiary operating abroad would be subject to the full U.S. tax when earned unless the earnings were reinvested in a less developed country or in itself.

(3) All income derived by U.S.-owned subsidiaries from U.S. patents, copyrights, and exclusive formulas and processes in the form of rental or royalty income would be subject to U.S. tax.

(4) The bill also contains a formula to deal with the income of sham offshore companies set up to evade payment of the U.S. tax. Under this formula, income from such nonqualified investment, described by the House Ways and Means Committee as not "necessary to the active conduct of a qualified trade or business of the controlled corporation," made after December 31, 1962, would be subject to U.S. tax provided the sales income is at least 20 percent of the gross income of the foreign corporation.

These changes in present tax policy are both equitable and desirable. However, we recommend one additional change which would be in conformity with the President's original proposal. While we would favor continuing the tax deferral privilege for income earned by U.S.-owned subsidiaries actually located in less developed countries, we would remove the deferral for all income earned in developed countries even if it is reinvested in less developed countries. Earnings of U.S. subsidiaries in developed countries should be subject to immediate full U.S. tax. Of course, if the parent company then desires after paying the U.S. tax to invest in less developed countries, the income actually earned in the less developed countries would be subject to tax deferral.

This change would accomplish two important objectives. It would encourage American firms, whether they are operating exclusively at home or partly through oversea subsidiaries, to invest in less developed countries. At the same time, the fundamental principle of equity as between taxation of income earned in the United States and income earned in other developed countries would be maintained.

Therefore, we ask the committee to make the tax deferral privilege apply exclusively to income earned by U.S. subsidiaries actually located in less developed countries. In such cases the firms who obtain the tax deferral should: (1) be operating new nonextractive enterprises which contribute to the overall development of the area; (2) undertake to maintain fair labor standards in their oversea operations; and (3) receive less than 10 percent of their income from sales in the United States.

Credit for foreign taxes.—Taxes paid by U.S. firms to foreign nations may now be credited against U.S. taxes. The President has recommended that such credits should not be permitted to reduce the total effective tax rate below 52 percent.

It is unreasonable for a U.S. firm with a subsidiary in Baltimore to pay, as all U.S. firms do, a 52-percent corporate tax rate, while a U.S. firm with a subsidiary in Rome can pay a much lower total tax rate because of crediting provisions. Surely it cannot be considered unfair for a total of U.S. and foreign taxes to be required to reach the U.S. rate of 52 percent, as the President has proposed.

Under present provisions, the tax paid by a foreign subsidiary to a foreign nation is deducted first from the profits and then again from the computed tentative U.S. tax. The effective rate, therefore, may be less than 52 percent. For example, if the foreign country's income tax rate is 30 percent on a U.S. company's foreign subsidiary's income, the combined effective rate of both U.S. and foreign taxes may be 45.4 percent instead of 52 percent. This results from the provisions which permit both the deduction from profits of taxes paid to a foreign nation by the subsidiary and the credit for taxes paid abroad subtracted from the tentative tax computed at the U.S. 52-percent rate when the income is returned here. The proposed revision would require the U.S. firm receiving returned income to report the profit of its foreign subsidiary without deducting the tax paid to the foreign nation. The foreign taxes would continue to be allowed as a tax credit but not as a deduction from foreign-earned profits.

The President's recommendation for eliminating this inequity from the law has been incorporated as H.R. 10650 as passed by the House. We strongly urge the Senate to retain this provision in the bill.

Earned income abroad.—Income earned by an individual citizen overseas is now exempted if he becomes a bona fide resident of the country. Even if he does not establish a foreign residence he may exclude $20,000 from his U.S. tax base if he remains abroad for a period of 17 out of 18 consecutive months. The President has recommended that this privilege be eliminated except that the first $20,000 received by individual U.S. citizens who reside in the less developed countries for 17 out of 18 months or establish foreign residence in such countries should be exempt from U.S. taxation. We support the President's recommendation.

Secretary Dillon has stated that 50,000 Americans were living abroad and claiming more than $500 million in exemptions in the year 1959. A citizen should pay the same taxes whether he makes a movie in Hollywood or in Rome. No possible reason can justify a difference in U.S. taxes for a U.S. auto executive who works in Detroit and the same firm's executive who works in Paris.

The President's proposals to apply a rational basis for taxing citizens abroad would require the following necessary steps: (1) Eliminate tax exemptions for U.S. citizens who reside in a foreign country; (2) eliminate the exemption for the first $20,000 of income for others who remain in a foreign country for 17 out of 18 months except in less developed countries.

This would equalize the tax treatment of income for all U.S. citizens, regardless of its source or its location.

The whole impact of the President's tax measures in the present partial reform tax package emphasize this important principle: equal treatment of the same amounts of income. This applies to his proposals for withholding on dividends and interest, repeal of dividend credit and exclusion, tightening expense accounts, as well as the elimination of the tax deferral on income earned overseas by foreign subsidiaries of American companies. Surely one's place of abode should not be a reasonable exception to this excellent principle. Income should be treated as income, regardless of its source, the type or place of abode of

the taxpayer. For this reason we strongly urge the enactment of this proposal to equalize tax treatment of U.S. citizens residing in this country and those living or staying abroad.

There is no need to give a person who wants to go to Europe an incentive to stay there for 17 out of 18 months just to avoid taxes. Very often, however, it is important to give an incentive to a person to go to a less developed area, where customs and conditions may be difficult for U.S. citizens. The U.S. Government and private companies need people to work in the less developed countries of the world. The United States wants to help those countries and wants to encourage its citizens to go to them to work. Like the tax deferral for income earned in less developed nations, the exemptions for individual income in such areas has a rational basis. In many instances, some incentive is needed. Unlike Italy or France, where luxuries are available to American travelers who will live there or go there regardless of tax laws, some nations of the world amount to "hardship posts" for Americans who are used to our way of life. There is, therefore, no inconsistency in establishing a $20,000 exemption for those who establish residences or live for 17 out of 18 months in a less developed area.

Unfortunately, the House did not concur in the President's recommendation in full. As passed by the House, H.R. 10650 makes no distinction between U.S. citizens living in developed or less developed countries. It establishes a ceiling of $20,000 as the amount which may be excluded with respect to the first 3 years an individual is abroad as a bona fide resident or has remained out of the country for 17 out of 18 months. However, it goes even further by increasing the exclusion to $35,000 for a U.S. citizen who has been a bona fide resident of a country or countries for longer than 3 years.

The House action appears to us to be thoroughly unwarranted. For reasons we have already stated, we see no reason why particular citizens should be placed in a privileged tax position simply because they are living abroad. Therefore, we urge the committee to adopt the President's recommendation and make such income subject to the regular tax except for the $20,000 exclusion for those who establish foreign residence in a less developed country or remain in such a country for 17 out of 18 months.

Other provisions relating to foreign-earned income.—We also support the following provisions of H.R. 10650 as passed by the House:

(1) Removal of the present exemption from U.S. tax of the share of U.S. shareholders in the earnings and profits accumulated in foreign invesement companies unless, as in the case of comparable domestic organizations, the foreign investment company elects to distribute currently 90 percent of its taxable income other than net long-term capital gains and it informs the U.S. shareholders of their share of any net long-term capital gains.

(2) Taxation as dividends, rather than as capital gains, of earnings or profits derived from taxable liquidations or sales or exchanges of stock in foreign corporations at the time the funds are brought back to the United States. However, as in the case of other foreign-earned income, we see no reason of deferral of tax until repatriation of income and therefore ask that this provision be changed accordingly.

(3) Elimination of exclusion of real property located outside the United States from the estate tax base.

(4) Requirement of annual submission of information with respect to operations of Americans abroad to give greater assurance that proper U.S. taxes are paid in the case of these foreign corporations.

SUMMARY

In brief, the position of the AFL-CIO on the major provisions of the bill now before you is as follows:

1. We oppose the costly investment tax credit proposal. While it will not fulfill the objectives of its sponsors, its enactment will dangerously distort the stable growth of the American economy. Short of outright rejection—which we urge—it should be recast to provide a temporary investment incentive solely for businesses substantially engaged in or affected by international trade. Otherwise, it simply becomes a multi-billion-dollar windfall, essentially enriching enterprises that neither contribute to a reduction in the balance of payments deficit nor the achievement of priority national goals. Moreover, most of its potential beneficiaries now suffer no lack of available private funds to meet expanded in-

vestment needs. In addition, we view a further acceleration of depreciation allowances, in lieu of the investment credit, to be totally unjustified.

2. We support the proposed withholding of dividend and interest income for tax purposes.

3. We support the President's request that the inequitable dividend credit and exclusion be repealed.

4. In order to end the business expense account racket we urge that the House bill be further tightened in the manner proposed by the administration.

5. We oppose the House proposal to allow tax deduction for lobbying for both substantive and procedural reasons.

6. We support the House proposal to terminate the capital gains treatment on the sale of depreciable business assets. However, this loophole closing should apply to profiteering from the sale of real estate as well as from the sale of personal property.

7. We support the increase in the tax liability of savings and loan associations and mutual savings banks proposed by the administration.

8. We urge the complete termination of all special tax exemption and deferral privileges now enjoyed by Americans living abroad and businesses operating overseas, except in the case of income earned in less developed countries.

The CHAIRMAN. Our next witness is Mr. Herman Kenin, president of the American Federation of Musicians. Mr. Kenin, please have a seat and proceed with your statement.

STATEMENT OF HERMAN KENIN, PRESIDENT, AMERICAN FEDERATION OF MUSICIANS, AFL–CIO

Mr. KENIN. My name is Herman Kenin. I am the international president of the American Federation of Musicians, AFL–CIO, and I appear here as spokesman for some 268,000 professional musicians.

First, I wish to record our wholehearted indorsement of the lofty aims sought by the President and expressed in the broad thrust of the legislation presently before this committee. As professional musicians, devoted trade unionists and patriotic Americans, we are in full agreement with those who say that tax inequities and opportunities for tax evasion should be eliminated. We see also the need for tax legislation to foster economic growth. We support every aspect of tax reform legislation except that which would destroy the jobs of tens of thousands of musicians and other employes in the entertainment, restaurant, and hotel fields.

Although sympathetic with the broad aims of this proposed legislation, I profess no expertise with respect to the economic theories and technical provisions of this bill. But, of necessity, I know something about the entertainment business and its importance to the domestic economy and the very large segment of workers who rely upon it for their livelihood.

Therefore, I shall direct my testimony to section 4 of the bill as passed by the House which deals with the disallowance of certain entertainment expenses.

Candor compels me to note that there have been abuses. There has been chiseling and there has been fraud. Neither of these abuses has been limited to the business expense field. Nevertheless, because there has been admittedly some abuse in this area the vague and ambiguous report of the House Ways and Means Committee accompanying this bill poses the very real danger of throwing out the baby along with the dirty wash. I am here to ask that this committee lead the Senate in eliminating these invitations to confusion and litigation.

Let me say to you, without any equivocation, that the American Federation of Musicians supports the literal language of the bill as adopted by the House. That language, properly read, interpreted, and enforced, will increase Treasury revenues without striking a death blow to employment in the entertainment industry.

The provisions which would disallow expenditures for facilities used primarily for the taxpayer's entertainment, amusement or recreation, is wholesome. We refer, of course, to yachts, game preserves, swimming pools, and the like.

The requirement that a taxpayer maintain ample and sufficient records so as to sustain claimed expenses is not unreasonable.

A limitation of $25 on gifts, even in this era of lavish spending, is not only reasonable but in good taste.

The language of section 4(b) which allows reasonable expenditures for meals and lodging, while traveling, is entirely acceptable. However, the legislative history should make clear that the reasonableness of such expenses will depend upon the particular facts and individual cases. Standards such as the nature of the taxpayer's business, the normal standard of living of the taxpayer, the locality in which the travel is performed and the environment of business competition must determine what is "reasonable," rather than any arbitrary standards set by the Revenue Service.

I come next to that part of section 4 which most directly affects musicians. The language of section 274(a) requires that expenses of entertainment activity can only be deducted where they are and I quote "directly related to the active conduct of * * * (the taxpayer's) trade or business." That is precise language. With that we have no quarrel.

However, Mr. Chairman, the House committee report beclouds this language. On page 20 of the report it is stated that the taxpayer under the above provisions will "have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure." On that page and on page 21, the report further expounds this section to circumscribe the environment, the number of persons entertained, the distractions" that obtain—and I presume by "distractions" the writers of the report mean the sounds of music, the twinkle of dancing feet, or the vocalizing of a barbershop quartette. This surprising exercise of semantics appears to us to be a patent attempt to disregard the plain language of the bill and to disallow all or most goodwill business entertainment expenses.

The House committee report is especially surprising in view of the history of this section of the bill in the Ways and Means Committee. Section 3 of the Ways and Means Committee earlier discussion draft would have flatly denied any deductions for goodwill entertaining. The American Federation of Musicians, along with four other entertainment and service labor unions and eight employer associations, joined in a statement to the House committee seeking a rejection of the proposal to disallow goodwill expenses. When we saw the language of the committee's completed bill we thought we had won. We thought we had saved a $2 billion industry from disaster; we thought we had laid to rest the specter of a government-legislated loss of approximately 200,000 jobs. We still think the plain language of the bill meets our objectives.

Despite the confused language of the House committee report, Congressman Keogh, a member of the committee, stated on the floor during the consideration of this bill that and I quote:

It was not the intention of the committee to disallow expenses for goodwill entertaining.

He added:

A test would be whether a prudent man in a similar trade or business might reasonably be expected to incur the expense.

Again, he stated that—

it was not the committee's intention to disallow goodwill entertaining, but merely to require that it be reasonable. Thus the committee never indicated during its deliberation, as suggested by the committee report, that the absence of the taxpayer, or his representative, from the entertainment activity would indicate that the entertainment was not directly related to the conduct of the taxpayer's trade or business.

End of quotes, as reported by the Congressional Record of March 28 on page 4885.

This fundamental conflict between the unfortunate committee report and the actual recommendations on the floor of the House creates a potential for endless haranguing and protracted litigation. Moreover, the seeds of doubt sown by the report will, unless laid to rest by this committee and the Senate, cripple the entertainment industry and seriously diminish income tax revenues from its several hundred thousand employees and the industry itself.

It is, and for decades has been, part of the fabric of our society to entertain for goodwill purposes. This kind of entertaining is not the sole province of the corporation. It has always been traditional for doctors, lawyers, insurance men, and other professionals to entertain clients and potential clients for goodwill purposes. Actual business discussions rarely take place on these occasions, but substantial and important business relationships are often founded on the goodwill and fellowship enjoyed at a night club, a restaurant, a musical show, or the opera. Moreover, goodwill entertaining is practiced at the highest levels of government and international affairs. I would doubt that it can be legislated out of our national life, but it could be damaged, and to that extent our musicians and other entertainers will be the chief sufferers.

This committee can, and I am sure will, establish a legislative history on section 274(a) which will specify that reasonable entertainment expenses—whether for goodwill or for the direct production of income—are deductible and that unreasonable expenditures are not. The concept of "reasonableness" is a familiar one in Anglo-American law. The simple test is that of "the prudent man."

At a time when the Congress and the administration are striving to solve the paradox of slack employment in an era of substantial progress, it is unthinkable that hundreds of thousands of workers depending upon the vast entertainment industry should become victims of an ambiguous and damaging misunderstanding of legislative intent.

The musicians for whom I speak cannot stand another setback in employment already so sparse as to afford a livelihood to only 25 percent of our professional instrumentalists. I need hardly belabor this point. There is, as you know, legislation pending in this Congress to

assist and guarantee the survival of the performing arts. High officials of the administration have publicly acknowledged the plight of the musician.

In view of the precarious conditions already existing in music and other entertainment employment, I say to you that the employees of this industry cannot afford to sit silent when vague, imprecise language threatens to distort the plain meaning of pending legislation—a distortion which could cause even greater hardship. Extreme care must be taken so that the livelihoods of those gainfully employed in the entertainment, food, and beverage industries will not be jeopardized unnecessarily.

Thank you for your courtesy and attention.

The CHAIRMAN. Thank you, Mr. Kenin.

The committee now will recess until 2:50. We have a joint session of Congress.

(Whereupon, at 12:10 p.m., the committee was recessed, to reconvene at 2:50 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

Before we call the first witness I will ask that there be inserted in the record this article from the Wall Street Journal of April 4, 1962.

(The article referred to follows:)

[From the Wall Street Journal, Apr. 4, 1962]

PANAMA PROTESTS A BILL FOR TOUGHER TAXING OF U.S. SUBSIDIARIES ABROAD

President Chiari of the Central American Republic tells President Kennedy that the administration-backed measure represents "undue interference in the internal affairs of Panama." The country is one of the oldest of the so-called tax havens; corporations there owe no tax on earnings outside its borders. The bill, passed by the House, generally would tax income of U.S.-controlled foreign subsidiaries when earned instead of when it is returned to this country in the form of dividends, as at present. The tax would be imposed directly on the owners in the United States regardless of when the subsidiary declares a dividend.

President Chiari argues that the latter feature in the case of United States owned Panamanian corporations means their profits in effect would be taxed while "still the property of Panamanians." This approach, he declares, is "almost equivalent to economic aggression."

The CHAIRMAN. The first witness is Charles W. Stewart, Machinery & Allied Products Institute.

Take a seat, Mr. Stewart, and proceed.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY & ALLIED PRODUCTS INSTITUTE; ACCOMPANIED BY GEORGE TERBORGH, RESEARCH DIRECTOR

Mr. STEWART. Thank you, sir.

Mr. Chairman and distinguished members of the committee, my name is Charles Stewart. I am the president of the Machinery & Allied Products Institute. My associate at the table is Mr. George Terborgh, our research director.

I should like to request that our full statement be entered in the record, if that please the committee.

The CHAIRMAN. Without objection, it will appear at the end of your testimony.

Mr. STEWART. And rather than burden you with reading from it, I shall try to move through some of the points and, perhaps, amplify a few, with particular reference, first, to the matter of foreign earnings, because I think it might be useful in terms of building what I would call a balanced record on this subject to refer back to some of the colloquies and comments that were made in the morning session.

First of all, as to constitutionality: I thought that the witness dispensed too quickly with what may be a rather fundamental issue. I notice that in the Ways and Means Committee hearings an extensive memorandum was filed with the committee by the distinguished director of the staff for the Joint Committee on Internal Revenue Taxation.

I do not appear before you as an expert constitutional lawyer. But I would call attention to the fact that that memorandum is in existence. It raises some fundamental questions.

It is not fully met, in my judgment, by Mr. Knight. Without indicating any disrespect for Mr. Knight at all, he is, of course, a member of the executive department which has taken a particular position on this subject. I think that it might be useful to consult outside counsel in terms of the constitutional questions that may be involved here.

I say that in due respect for all parties concerned, but I did feel that the matter was dealt with too abruptly or dispensed with, I believe was the word used.

It seems to me also that we moved very blithely this morning over one fundamental question, namely: Why are companies going abroad?

There was reference made to what is considered by Senator Gore and, apparently by the administration and, perhaps by others, to be an artificial incentive.

But I think the problem runs much deeper. I would call attention to the proposition that in our judgment, based on long experience with the capital goods industries, that investment abroad is indeed "forced" investment. It is forced by economic facts. It is not investment purely by choice.

It is forced by a disparity in labor rates, for example, particularly with respect to those products like capital goods which have a high labor content in terms of their production costs.

I refer the committee to an excellent study on "Costs and Competition, American Experience Abroad," published by the National Industrial Conference Board in August 1961.

My point is simply this: that if we are to deal with the forces that move business outside the continental limits of the United States, we must go much further in order to understand the problem than merely to look at the tax aspects.

Indeed, in our judgment, the tax aspects are not as central as such items as the one I have just referred to.

There were some rather general conclusions drawn this morning with which we are in fundamental disagreement, and I point to them merely to make sure that the disagreement is underlined.

It was suggested that foreign based companies not only benefit from a tax deferral but that they also import into the United States and compete with U.S. exports in third foreign markets.

Based on the experience that we have had with the capital goods industries which manufacture the largest single exported class of product which this country has, namely, machinery and allied products, this is largely not the case.

Our figures indicate that the amount of imports that are brought back into these United States from subsidiaries of American capital goods companies is minimal. They are not even worth talking about.

This is not to say that this condition will continue forevermore but, in our judgment, it is true and, I think, incontrovertibly so, at the present time.

Secondly, for the very reason that I previously indicated, American business goes abroad largely under competitive force. It goes abroad, to a large extent, because it cannot, in individual situations or in individual industry situations, compete effectively for export purposes from this country.

So that for the most part, the shipments to third countries from bases abroad are not in competition with U.S. exports from this country.

I know of no capital goods executive, not a single one, who, given a choice, would rather do business from a foreign location than do business from his U.S. home base, and I say that without the slightest hesitation.

Another point this morning that I think needs to be met head on: There was an impression created as a result of testimony and questions, that there is an automatic displacement of investment opportunity in the United States, and displacement of U.S. employment in the United States as a result of investment abroad.

This may be true to a limited extent, but we feel it is distinctly a very limited extent, for the reason that I have indicated previously.

For the most part, companies go abroad for a particular marketing or production purpose, when they do not have an equivalent or alternative opportunity in the United States in reference to a particular product line.

So that there is not, based on our experience, this displacement that is referred to.

There was a reference made this morning in a colloquy between the distinguished Senators from Kentucky and Tennessee to the effect of foreign investment on exports from the United States. Although it is conceded even by exhibit III in the Treasury testimony submitted on Monday of this week, that there is some effect, the actual effect is neither shown by exhibit III nor was it fully brought out this morning. I would like to take the liberty of making a few more comments on that point because we feel it is central to the question of understanding the economics of foreign investment.

In the first place, there is no question but that to some extent a subsidiary abroad generates production by the U.S. parent of components, certain specialized products or auxiliary items which may not be efficiently manufactured in the foreign country, or where there is another business reason for this kind of an export shipment.

In addition, we need to bear in mind that this world is going nationalistic in a big way. There are many countries of the world into which you cannot import as a capital goods producer because of restrictions

against exports from the United States. They want the product produced within the territorial limits of that particular country.

I do not say this in criticism, because it is not my business to criticize international policy of other countries. But I do feel we need to recognize that this barrier to U.S. exports does exist.

As a corollary to that proposition we have found from experience that when an American company does, in fact, operate abroad within a particular country, it finds some of these prohibitions relaxed to a rather substantial extent. The foreign country is much more interested in cooperating with respect to import permits than it was before.

There is another aspect of a foreign operation that needs to be amplified. There is not simply the benefit of auxiliary equipment and components going from the United States to foreign subsidiaries, but these foreign subsidiaries provide a marketing force, a know-how group, a group of men who become international trade-minded. There is not a single company in the capital goods industries that goes abroad that does not benefit in terms of its total export position, its total worldwide position, its total posture in international trade thinking by virtue of being there.

So you cannot measure the benefit of foreign subsidiaries to the balance of payments problem or to the health of the domestic based industry simply by looking at the export figures.

I should say, in passing, we do not share Mr. Ruttenberg's enthusiasm for the statistical techniques and interpretations employed in exhibit III attached to the principal statement of Secretary Dillon.

With due respect to the analysts who prepared that appendix, exhibit III, we have only had 2 days to look at it. The comments which we offer in our principal statement with respect to exhibit III have been made within those time limits. But I would like to point to one or two points that I think are rather significant.

In the first place, the document rests on the concept of neutrality, and we heard a good deal about tax neutrality this morning.

Now, neutrality means different things to different people; and neutrality means something different to me than it does to the first witness this morning.

I think a much more appropriate concept of tax neutrality in this field is, as was suggested by Senator Morton, to place the American foreign-based company in a position of parity from a competitive standpoint with the companies with which he has to live in a competitive sense. This is distinguished from trying to achieve tax neutrality between a domestic company doing no foreign business and a domestic company which has a foreign operation.

Let me carry the neutrality argument one step further. We have had this privilege in the tax laws since 1913 as far as deferral is concerned.

During that period of time, within the proprieties of the law and for very sound economic reasons, many companies have gone outside the continental limits and are operating there.

This causes much more concern to some than it does to me. But, as a matter of fact, it is true. There is not much sense of equity or neutrality at this stage of the game to discriminate against the small business or the medium-sized competitor who might like to invest overseas as compared with those companies who are already planted well overeas. This is not neutrality, as I understand neutrality.

Furthermore, in terms of risk there is a considerable difference between operating in the United States under our Government and operating, if you will, in many other countries which I see no reason to name.

You are at the mercy, so to speak, of different approaches to government. Once again it is not my function to criticize the policies of these governments, but they are different.

It seems to me that any true approach to neutrality must recognize that these differences do exist.

Gentlemen, if you would be interested in exploring further the true implications of the effects of foreign manufacturing, in particular, but also marketing organizations, on the total health of U.S. companies and on their exports, I refer you to page 12 and the following discussion in the appendix to the statement which we have submitted.

I would like to take about 3 more minutes to throw out some general comments in this area which baffle me in terms of national policy. This is done, once again, not for the purpose of being facetious or of being sharp or criticizing unduly, but merely to bring the issues into focus.

I am still not clear, gentlemen, as to what the purpose of the foreign earnings sections of this bill is. It seems to me that there is a good deal more of a punitive purpose behind these provisions than was indicated at the last question and answer period in the hearings this morning.

It is true that it is said that it is desirable to remove an undue tax advantage. But also great emphasis is placed on the notion of comparisons between dollar return on investment in the United States and dollar return abroad, and I wonder which one of these arguments is the primary argument.

My own judgment is that there runs through the philosophy of these provisions a good deal of evidence that this country wishes to frown on foreign investment, and I say that with due respect to Senator Gore, whose last comment was to the contrary.

Now, I am also baffled to some extent by another aspect of foreign investment philosophy. When I compare the spirit and philosophy of this bill with the spirit and philosophy of H.R. 9900, I wonder if we are not moving in two directions at the same time, one isolationist, and one very much liberal-trade minded. I wonder how businessmen can possibly reconcile the two approaches to international trade.

I have referred to the fact that in my judgment the provisions of the foreign earnings sections of this bill are absolutely contrary to the best interests of this country in terms of exports, and that is developed in detail in our statement. Yet there has been suggested in a recent communication to this Congress by the President that we ought to have an export coordinator in the Department of Commerce.

I can say to you again, with due respect to the Department, that the impact that foreign investment has on exports is much greater than any administrative system we can devise within the Government in this country.

I suppose that it would be unfair to the total picture of national policy if I did not mention the fact that business has an increasing concern with respect to the rôle that it might play and should play in terms of carrying out foreign economic policy, indeed, even in the national security area using the arm of foreign investment.

We recently were asked by Mr. Murrow's organization USIA, if we would cooperate through the companies that worked with the Institute in attempting to identify key businessmen overseas who might be helpful spokesmen informally for the American way of life.

It seems to me that this is the best system of foreign aid that we have, namely, foreign investment that, like the Peace Corps. involves the principle of people-to-people contacts. I cannot understand any reason for wanting to discourage foreign investment and the favorable factors that go with it.

The foreign trade program which has been brought to the attention of the Congress and is now being heard in the House Ways and Means Committee, is expressly related to concern over the Common Market.

Yet one of the obvious ways of meeting the competition that is implicit in the Common Market is investment within the Common Market. Indeed, one of the reasons that exhibit III, in our judgment, is off target is the fact that it fails to recognize that the great bulge in foreign investments which has taken place from foreign sources in the United States during the period analyzed was due largely to a need, an absolute lifeblood need, to penetrate the Common Market in order to survive international competition.

Now, I want to say a word about tax policy objectives as related to these provisions.

I have read Mr. Surrey's and Mr. Dillon's speeches on what criteria should be employed in terms of tax policy, and I am familiar with the principles which this committee likes to apply in looking at broad tax questions.

I have already dealt with the subject of neutrality. Much stress is being placed on economic growth, and I would like to say, in my judgment, if one applies the philosophy of the foreign trade bill, if we look down the long road in terms of balance of payments, and in terms of the international competitive position of the United States, that long-run economic growth will not be stimulated by these provisions.

There is also a little criterion which is given great emphasis called simplicity, and I am sure you gentlemen will agree with me that if you read the foreign earnings provisions of this bill you are not satisfying that criterion by a long shot.

I want to say, further, in reference to foreign earnings, a brief word about certain interrelationships which are missed in the kind of conclusions which were drawn this morning.

As a practical business matter, gentlemen, and I speak from long experience in dealing with foreign traders, you cannot separate exports from investment and from licensing. You cannot divide up American business operations in the foreign field and move exports over here and foreign investment over here and say that we will frown on this but we will stimulate that.

American business cannot be run that way. Exports are interrelated, intertwined with foreign investments and with licensing.

You cannot separate the domestic operation of a company from its foreign operation. They are intermingled. They work together. They benefit from know-how overseas as well as giving know-how to the oversea operation.

You cannot separate doing business, in our judgment, in a developed country from an underdeveloped country. We feel that to shut off the opportunity to invest foreign base earnings from a developed country into an underdeveloped country will cut off a major source of funds for that purpose.

Personnel travel back and forth, marketing people exchange ideas, organizations blend; you cannot split them up. Business does not operate that way.

You cannot separate benefits to the domestic market from foreign trade, whether it is carried on through foreign investment or otherwise.

Now, gentlemen, I bring you these points on foreign earnings with a conviction that aside from the technical points which we have dealt with in detail in our statement, there is a good deal of fundamental basic thinking in terms of international economic policy, commercial policy, tax policy and theory that, I think, has to be done with respect to this bill before it is eligible for final consideration by this distinguished committee.

I do not think that all of the long-range, broad issues have been brought to bear I certainly do not feel they were implicit in the testimony presented to you this morning. I ask that the committee rethink the philosophy underlying the foreign earnings provisions.

I would like to say a word about the investment credit. George Terborgh, our research director, is here. We have presented to you what we consider to be a comprehensive brief on this subject.

I think the institute's main business is capital formation and capital investment. We like to think we know something about these subjects. We are convinced that we have an economic growth problem in this country. We are convinced further that capital investment is at the heart of that problem and, finally, in the equation we feel that a sound stimulation to capital investment is equally important to the solution of the problem.

We do not look upon the investment credit as the only answer, but we certainly do not reject it because it is novel. Indeed, we think, as Mr. Terborgh has developed in the study attached to our paper, that it has many unique advantages which should be looked at objectively and reexamined in the light of the overall objectives of the President, of the committee, and of the country.

We have submitted testimony to you, also, in our written statement on the matter of expense accounts. I hope that you will receive this material in the spirit of the institute not wishing to sponsor improper evasion.

We do feel that some more thought might be given to the question as to whether there is an effective alternative to new elaborate provisions in the law by utilizing fully the administrative process.

If it is the judgment of this committee that it should act along the lines of the House provision or expand upon it or contract it, we have pointed to a series of questions, in terms of interpretation, at the end of that section of our statement which we feel deserve further consideration.

We have also covered in the statement the matter of capital gains treatment versus ordinary income treatment of disposals of depreciable assets. Within the framework developed in our statement we offer no objection to this change.

If you gentlemen wish to pursue the investment credit further, I hope that you will take advantage of Mr. Terborgh's presence and direct questions at him.

I would like to add to what I have said about it, two points:

First of all, we do not view the credit as a loophole or as a subsidy or something that is so unique that it is unworkable. We develop that point in detail in the statement, and Mr. Terborgh can amplify it for you if you wish to develop it on questions.

We feel that if the committee should choose to act favorably on the credit concept, that it should adopt the changes recommended by the Secretary on Monday with reference to the level of the credit, moving it to 8 percent and changing the 25-percent figure to 50 percent.

I should like to make one futher point clear with reference to the credit. There has been some indication in statements made, both within Government and outside of it, that there are no elements of the business community which favor the investment credit. I should like to correct that impression. We have favored it since it was changed to a flat-rate credit versus the originally unduly complicated system.

We bring to you today our presentation which favors it, and we know of a number of other organizations which feel similarly.

That concludes, gentlemen, my oral summary. We appreciate greatly the opportunity to present this to you. Please excuse the length of this written document, but we are dealing with a terribly complicated set of provisions.

The CHAIRMAN. Senator Kerr.

Senator KERR. Briefly, you favor the investment tax credit provision?

Mr. STEWART. Yes, sir.

Senator KERR. You favor changing the tax treatment of foreign income?

Mr. STEWART. We do not favor changing the—let me answer that question this way, and briefly, sir.

We think the philosophy underlying the present provisions needs to be completely reexamined. On the basis of the philosophy and the direction in which we think these provisions take us, we oppose the entire set of foreign earnings provisions. This does not mean, however, that we would oppose necessarily provisions directed solely at abuses within this area. That is a conditional answer, sir.

Senator KERR. You recognize the fact, or you take the position in that there are abuses with reference to the present laws affecting the bringing back of money earned abroad or leaving it there and escaping taxation?

Mr. STEWART. That is right, sir.

Senator KERR. Have you made specific recommendations in that regard?

Mr. STEWART. No, sir, we have not, because frankly, we feel that the first proposition is that we must, we wish to, encourage the development of a basic program of objectives in this area.

We feel that the abuse area is thoroughly obscured by these provisions, and that really the attack is made on foreign investment per se.

Senator KERR. Have you prepared a document on the abuses that you refer to, identifying them and making specific recommendations for their correction?

Mr. STEWART. No, sir; we have not.

Senator KERR. Would you do that?

Mr. STEWART. You have specific questions with respect to abuses?

Senator KERR. Sir?

Mr. STEWART. Do you have specific questions with respect to abuses that I might answer, sir?

Senator KERR. Well, the specific question is, and I did not want to go into it completely at this time because I felt that in the interest of time we could do it more expeditiously——

Mr. STEWART. All right, sir.

Senator KERR. No. 1, what are they? Identify them and tabulate them. No. 2, what are your suggestions as to corrections?

Mr. STEWART. All right, sir; we will endeavor to present material to you in response to that question.

Senator KERR. For the record.

Mr. STEWART. Yes, sir.

(The information referred to follows:)

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., April 11, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: You may recall that in the course of our testimony in public hearings on H.R. 10650 Senator Kerr requested us to submit our views with respect to the following:

(1) An identification of tax abuses under the foreign earnings provisions of the Internal Revenue Code.

(2) Our suggestions as to how such abuses might best be overcome.

This letter is in response to Senator Kerr's request.

We should observe at the outset that the institute's view of the matter is necessarily limited to the experience which it has gained in working with manufacturers of capital goods and allied equipment. In a complex field such as taxation of foreign earnings, reasonable—even expert—observers may differ substantially as to what constitutes an abuse. Moreover, the institute is obviously not in the enforcement business, and thus cannot claim any special knowledge of such abuses as may exist in this area. However, upon the basis of Treasury testimony in these hearings and related hearings before the Ways and Means Committee last year and such general information on the subject as has come to our attention, we are inclined to believe that practices which might be characterized as abuses of the foreign income provisions of the Internal Revenue Code are most likely to be found in the following areas:

1. "Sham" or "letter drop" corporations.

Comment. Obviously, these terms require further definition. Our notion of a "letter drop" corporation is a foreign subsidy, customarily organized in a low-tax country, which has little or no facilities or staff at the scene of the subsidiary's operations, whose management functions are slight or nonexistent, and which, all factors considered, represents little more than a mailing address.

2. Reinsurance by foreign subsidiaries of domestic risks. Based solely on information available to us, we are inclined to believe that reinsurance abroad of domestic risks by foreign subsidiares of American insurance corporations—when adequate reinsurance facilities are available in the United States—represents a practice which may require administrative action.

Comment. We should emphasize that the institute can claim no expertise in this field and it may well be that such reinsurance corporations perform useful economic functions not readily apparent to us.

3. Interest-free loans from a foreign subsidiary to a U.S. parent corporation where this is equivalent to a dividend distribution.

4. Improper pricing of product sales by parent corporations to foreign subsidiaries.

Comment. However, this problem can be dealt with adequately through enforcement of the existing section 482.

5. The creation of a subsidiary abroad largely or wholly as a tax shelter for the conduct of a single venture.

Comment. Where a foreign subsidiary corporation is established for the sole purpose of consummating a single undertaking and is liquidated shortly thereafter, particularly where all facilities for the consummation of such enterprise are already available in the United States, it would seem fairly clear that the purpose of the foreign subsidiary was solely tax avoidance.

We must emphasize again that our knowledge of alleged tax abuses in the foreign earnings area is necessarily tentative in character and based upon our limited knowledge of such situations. However, there is one aspect of the matter on which we have no doubts whatever: Most of the arrangements now practiced on a continuing basis by foreign subsidiaries of manufacturing companies in the capital goods and allied product industries are not abuses. On the contrary, they have, and increasingly will, contribute importantly to a favorable balance of international payments, to the improvement of domestic employment, to the maintenance of the American position in international markets, and to the total revenues of the U.S. Treasury.

Our reasoning and support of these assertions appears in considerable detail in our oral testimony and the written statement presented to this committee on April 4, 1962. As we pointed out at that time, numerous perfectly legitimate foreign subsidiary arrangements would be penalized by one or more of the provisions appearing in H.R. 10650. Before proceeding to an examination of possible solutions to the problems enumerated we should like to identify again briefly foreign subsidiary arrangements which do not constitute tax abuses. A representative list of such arrangements appears below:

1. Manufacturing subsidiaries in foreign countries.

Comment. It is difficult to conceive why, in and of itself, the establishment of a manufacturing subsidiary abroad, in a country having corporate income-tax rates approximating that of the United States, can possibly be considered as a tax abuse. Nevertheless, under the provisions of H.R. 10650 in the form now proposed, part of the income of such a subsidiary might be subject, in effect, to direct American taxation.

2. Subsidiaries in low-tax countries which perform bona fide management functions on behalf of the parent corporation in such areas as sales, service, research and development, or general management of the parent corporation's foreign operations.

Comment. An impression has been created that a subsidiary established in a low-tax country represents a tax abuse per se. Obviously, taxation may be an important factor in the establishment of such subsidiaries but the organization and operation of many such subsidiaries belie the suggestion that the sole—or even controlling—reason for their establishment was the tax advantage. Where a company has numerous foreign manufacturing subsidiaries, it is desirable to centralize control of such operations and the establishment of a controlling subsidiary must necessarily take into account proximity of its location to operations controlled, and markets to be served, the stability of government, the availability of transportation and financial facilities, etc.

3. Patent and know-how agreements.

Comment. It seems evident from the provisions of H.R. 10650 that earnings from patent and know-how agreements with foreign manufacturers are the products of contracts which are treated as abuses per se under the bill. The fact is that such agreements are usually one—and only one—step in the process by which an American company establishes itself in foreign operations. Moreover, the earnings from such agreements, when permitted to accumulate under the present provisions of the code, make possible the creation of a sound capital base for expansion into manufacturing, thus avoiding any capital drain on the parent corporation in the United States. Such agreements have been and are immensely valuable to the economy of the United States, and to suggest that the mere existence of such agreements constitutes a tax abuse is to ignore completely the present realities of foreign trade.

SOME POSSIBLE STANDARDS

Necessarily, the determination of tax abuses in the foreign earnings area will involve discriminating judgments on the part of the Internal Revenue Service. We think, however, that the usefulness of our identification of abuses may be

extended by suggesting for the committee's consideration certain tests for application in appropriate cases. Our tentative suggestions, as requested by Senator Kerr, as to criteria in this regard appear below:

1. Was the sole purpose of establishing an oversea subsidiary the avoidance of taxes?

Comment. We would be the first to admit that any answer to this question, without more, may be largely a subjective judgment. To answer the general question, one must first answer certain derivative questions. Among them are the following: Was the oversea move necessary to maintain or enlarge the company's position in world markets? Was the subsidiary abroad formed largely or wholly as a tax shelter for a single venture? Does the foreign subsidary perform bona fide management functions or is it merely a "letterdrop" organization?

2. Are sales transactions between the parent and subsidiary priced at sums reasonably comparable—after making due allowance for lower selling costs and special circumstances—to sales of the same or similar items to third parties?

AFFIRMATIVE ACTION

Having due regard for those objectives of national policy which our statement filed with the committee on April 4 refers to, we suggest that the foreign earnings provisions of H.R. 10650 are probably altogether unnecessary.

We would be the first to acknowledge that there has been available to the Internal Revenue Service heretofore insufficient information respecting the details of U.S. corporations' foreign operations. More importantly, there appears to have been inadequate enforcement by the Service of its presently available authority. In short, we believe that abuses can be overcome and most, if not all, the problems in this area solved by administrative action. To accomplish this, there might be, for example, full utilization of the pricing authority provided by section 482 as well as the authority to act against "sham" corporations under the doctrine of such cases as *Moline Properties, Inc.*, v. *Commissioner* (319 U.S. 436 (1943)). In addition, we suggest:

1. An enlargement of, and, if necessary, additional training for, the staff of the Office of International Operations of the Internal Revenue Service. It is our belief that a lack of enforcement in the foreign earnings area is largely traceable to insufficient personnel and, quite possibly, to inadequate training in the details of foreign operations by such staff as the Office now has.

2. This committee is, of course, familiar with the addition some 2 years years ago of section 6038 to the Internal Revenue Code which requires detailed annual information reporting on certain items by a domestic corporation with respect to transactions with foreign subsidiaries. We are familiar generally with administrative regulations adopted by the Internal Revenue Service in accordance with the terms of this expanded statutory requirement for informational reporting, and it is our conviction that such information should provide a basis for eliminating most of those abuses to which the Treasury Department has referred in its testimony and which we have identified above. Less than 2 years have elapsed since the adoption of this new code provision and its implementation in Treasury regulations. These new provisions should be given sufficient time to prove themselves before additional legislation is adopted and, indeed, before expanding the existing reporting requirements themselves—as proposed in H.R. 10650.

This concludes our comments in response to Senator Kerr's request of April 4. We trust that they will be helpful to the committee in its consideration of H.R. 10650 and we appreciate the opportunity of submitting them.

Respectfully,

CHARLES STEWART, *President.*

Senator KERR. If I understood you, you said that the tax elements of this bill are not esential either to improve or reinforce the position of manufacturing facilities in this country in competing in the world market.

Mr. STEWART. I do not know that you understood me correctly. I was saying, sir——

Senator KERR. You made the statement, I believe, that the tax aspects are not essential.

Mr. STEWART. I think you misunderstood me, sir. May I clarify what I intended to say?

Senator KERR. Yes.

Mr. STEWART. I was trying to make the point, sir, that in my judgment the results of enactment of these provisions in the foreign earnings field will not have the salutary benefits which are attributed to them by such witnesses as the one who appeared this morning with respect to the favorable impact on the domestic economy. That is what I intended to convey.

In other words, to be specific, if a dollar is discouraged from investment abroad, it does not necessarily follow, as the Senator from Kentucky pointed out, that there is an equivalent alternative opportunity to invest that in the United States in the particular product line involved.

It does not follow necessarily that because a company which formerly employed—I know of one situation which formerly employed—2,000 men in Milwaukee, and now employs 3,000 in England, would, if these tax provisions were removed, have 3,000 men back in Milwaukee. There are other factors——

Senator KERR. If which tax provisions were removed?

Mr. STEWART. Foreign earnings provisions.

Senator KERR. In the existing law?

Mr. STEWART. No, in the bill. It was alleged this morning, Senator——

Senator KERR. You mean a company went to England because the bill was introduced?

Mr. STEWART. No, no. I am afraid I am not communicating very effectively, sir.

Senator KERR. Maybe my receiving set is not in good shape. [Laughter.]

Mr. STEWART. I was exposing what I consider to be a fundamental fallacy of those who support the foreign earnings provisions.

Senator KERR. You said a firm had 2,000 men employed in Milwaukee that now has 3,000 men employed in England who would now be employed in Milwaukee if it were not for the provisions—if it were not for what?

Mr. STEWART. It is alleged by some who favor this kind of a provision that the employment which was lost to England would not have been lost if there had not been the attraction of foreign earnings provisions to take the company to England.

The fact of the matter is that the company could no longer export economically from the United States because it had lost its export international competitive position.

Senator KERR. Why?

Mr. STEWART. For a lot of reasons that have nothing to do with tax, one of them being disparity in labor rates.

Senator KERR. What are the other things?

Mr. STEWART. General rehabilitation of foreign business abroad with our assistance and as to that I do not criticize the programs in which we are engaged. I am just responding to your question.

Efficiency of competition which is something we look to see and should expect; general change in technology, a lot of factors.

Senator KERR. Better technology there than here?

Mr. STEWART. In some situations this happens.

Senator KERR. Would you give me a specific instance where there is better technology for the production or creation of and the building of a competitive facility abroad than here?

Mr. STEWART. When I said better technology, Senator, I did not mean necessarily that it is better than the United States. I was saying that it is——

Senator KERR. That is what we are talking about, there instead of here. You said it was there instead of here because of better technology.

Mr. STEWART. Improved technology over what they had before in the sense that their competitive position is greatly strengthened overseas so that when you get to a price differential the United States company is no longer in the position of having such a tremendous advantage from a technological standpoint that it can wash out a price differential.

I did not mean necessarily that in a large range of cases the technology abroad is superior to that of the United States.

Senator KERR. I would think the technology is kind of like water, it kind of seeks its own level, and if there are technological improvements here they are available there or vice versa.

Mr. STEWART. That is right.

What has happened, though, Senator, as a general matter is this: Postwar there was a tremendous market for American goods, particularly heavy goods, all over the world. You know this, I am sure, better than I in view of your wide experience.

But this market at that time could not be penetrated from foreign lands because some of them were completely wrecked. They have since been rebuilt. They now are in a position where they are a much more effective competitor, and I am not criticizing this, I am just saying this is what happened.

Senator KERR. I understand.

Mr. STEWART. At the same time, the disparity in labor rates has not closed.

Senator KERR. We all recognize that is what has happened. We all recognize that there are differentials in labor rates.

Mr. STEWART. To be sure.

Senator KERR. One of the arguments advanced for this bill is that it would eliminate or remove, in part, the advantageous position which a company can have in a foreign country as compared to what it would be if they had it here.

Mr. STEWART. I understand.

Senator KERR. There is not any doubt but what there are better tax incentives for the building of industrial facilities in many other countries than there are here, is there?

Mr. STEWART. That is true.

Senator KERR. So that they not only have the advantage of the difference in labor costs, they certainly have the advantage of the more favorable tax treatment, do they not?

Mr. STEWART. That is true.

Senator KERR. Would this remove any of the advantage they now have taxwise?

Mr. STEWART. The proposed bill would put the U.S. foreign subsidiary in a much less competitive position than he is now vis-a-vis his foreign competitors. In my judgment it would——

Senator KERR. I would just tell you a little secret. I get along fine with you until you get to the "vis-a-vis." [Laughter.]

Mr. STEWART. All right. The proposed bill would reduce the competitive position of the American subsidiary against his foreign competitor overseas.

Senator KERR. By reason of this bill?

Mr. STEWART. By reason of this bill.

At the same time, Senator, it would not transfer, in our judgment, because of the other factors to which I have referred, a substantial benefit to the domestic market in terms of capital investment here and jobs here because we believe that it is an illusion that American business solely for tax reasons perfers to invest overseas. It is motivated by the other reasons which you and I have just discussed.

Senator KERR. I thought you said they were motivated by the compelling reason of the competitive position.

Mr. STEWART. That is right, sir.

Senator KERR. Well, you told me that one of the advantages of the competitive position there was a better tax treatment, did you not?

Mr. STEWART. That is right.

Senator KERR. Now, are you telling me that this bill would not remove any of that, would not move toward the position where a part of that tax advantage would be neutralized?

Mr. STEWART. I am not saying the tax advantage would not be effected. I am saying there would not be the favorable effect on domestic industry and domestic jobs which is alleged by certain who favor these provisions.

Senator KERR. Let us forget how much they say or somebody says that this provision would improve the situation. Do you think it would improve it at all?

Mr. STEWART. It would not improve it substantially, and the adverse effects of it greatly overweigh any advantage that would acrue to the domestic market.

Senator KERR. Now, the adverse effects of the tax credit?

Mr. STEWART. No, not the credit, the adverse effect of removal of the earnings.

Senator KERR. That is what I am addressing myself to right now.

Mr. STEWART. The credit?

Senator KERR. Yes, sir.

Mr. STEWART. Would you mind restating your question again, because I thought we were on foreign earnings.

Senator KERR. Would the tax credit provisions in this bill remove a part of the tax advantage that now exists in favor of an American industry being built in a foreign country instead of here?

Mr. STEWART. I think that there would be some adjustment as a result of the tax credit. I would answer that question, "Yes."

Senator KERR. Well, now, does that mean that you think a part of the unfavorable situation would be removed?

Mr. STEWART. I do. In other words, I gather that the point which you are making, and I think very properly, is that to the extent that it is proper to compare the position of the domestic producer with the foreign subsidiary in terms of this neutrality——

Senator KERR. I am comparing the foreign competitor, whether it is his own subsidiary or somebody else's.

Mr. STEWART. I though you were making the point, Senator, that the credit together—that the credit would offset some of the undue advantage which some people feel the foreign subsidiary has over the domestic producer, and I answered that that I thought it would if it is considered to be an undue advantage. I do not treat it as such.

Senator KERR. Either you do not understand my question or you did not answer it or I did not understand what you said.

Mr. STEWART. May we try again, sir? May we try again because I would not want to leave this point unanswered.

Senator KERR. You talked about barriers against our products being shipped into other countries being determinative in the decision to build facilities there instead of here existing in many places and in many countries.

Mr. STEWART. I do not imply determinative. I said it is a strong factor involved in the decision.

Senator KERR. I must say I thought you said it was determinative, and I thought I agreed with you.

Mr. STEWART. All right, we will say in many cases it is determinative.

Senator KERR. Does that apply to the Common Market countries?

Mr. STEWART. To some extent. It is more commonly applied rigorously in the underdeveloped and Latin American countries, but it is applied to some extent in the Common Market countries where you must go through an elaborate procedure of permits to build and import permit, and so on, but I would say it is not as rigorously enforced there as it is in certain of the underdeveloped countries.

Senator KERR. If that is correct, how is it that we have a very favorable trade balance with countries in the Common Market, if the barriers are there that would tend to prevent our exporting to them?

Mr. STEWART. Favorable balance figures, Senator, as you know, are aggregates——

Senator KERR. Are what?

Mr. STEWART. Are aggregates.

Senator KERR. Do you have another word for that? [Laughter.]

Mr. STEWART. Favorable balance figures are a total mix of products. Most machinery products, for example, in many countries within the Common Market are not admitted by Common Market countries unless they represent some special contribution technlogically to that country.

Let me give you a specific example. There are many standard machine tools that have been in the past shut out of certain Common Market countries because such standard tools could be made and have been made in those countries.

If, on the other hand, the company in the United States builds a special tool which is not made in counterpart in one of these Common Market countries, then they are inclined to lower their barrier.

Now, I recognize this administration is undertaking a very thorough job to correct some of these problems, and undoubtedly as the result of the last negotiations which have taken place, which I have not had a chance to study fully, some further improvement has taken place.

But even with that improvement, and with the prospect of what the Common Market may do in terms of its total outer tariffs, and also with respect to other areas of the world, the problem which you and I are discussing is very much with us and will be with us for a very long time.

Senator KERR. You are not hopeful that there is any solution to this problem, are you?

Mr. STEWART. No, sir. I do not take that position at all.

My solution to this problem is simply this: That American business has to be mobile, it has to be dynamic, it has to compete. It has to live with the facts of life.

It should not cry about the fact that there has been a rehabilitation in Western Europe. It should not cry solely about the rise of the Common Market because it has great national security implications for this country. But, at the same time, it should not be hobbled by tax provisions such as are proposed in this bill.

Senator KERR. Then your primary objections are to the tax proposal in this bill?

Mr. STEWART. The foreign earnings provisions, yes.

Senator KERR. That is the primary message you have here?

Mr. STEWART. Plus a support of the investment credit which we favor. That is the primary message.

Senator KERR. You will supply the answers to my other questions?

Mr. STEWART. We will endeavor to do so.

Senator KERR. Thank you.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. Just this one question, Mr. Stewart.

When you appear here for the Machinery & Allied Products Institute, does that include farm machinery?

Mr. STEWART. Yes; it does.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Senator Douglas?

Senator DOUGLASS. Mr. Stewart, I regret that other duties prevented me from coming in when you began your testimony. I have glanced over your written statement, and I would like to address some questions to section 4, entertainment expenses, which you covered in your statement.

Mr. STEWART. I shall try to answer them.

Senator DOUGLAS. I take it that what you would like most is to have section 4 stricken from the bill; is that correct?

Mr. STEWART. Let me answer it this way, sir, and I do not mean to be evasive: We feel as to section 4 that the Congress needs to reexamine further whether the abuses which are acknowledged to be in existence can be dealt with administratively.

I have read Commissioner Caplin's memorandum, I know the view that the administrative recourse is not sufficient. We are not satisfied that that is the correct answer, sir.

Senator DOUGLAS. Well, isn't your position somewhat more definitive than that? You say:

We think these administrative measures should be given a reasonable opportunity to overcome enforcement shortcomings since problems in this area, in the very nature of the case, are and must remain primarily administrative matters.

Mr. STEWART. I think your interpretation is a fair interpretation.

Senator DOUGLAS. So the inference which you drew from this was that whatever your attitude in the future might be, as of the present you do not favor any further legislation on this subject?

Mr. STEWART. I think that is a fair conclusion, sir.

Senator DOUGLAS. So that you think that there are sufficient administrative remedies?

Mr. STEWART. And we point, I believe, sir, to several steps which we have observed being taken to deal with the problems which the Treasury feels are central in this area.

Senator DOUGLAS. You think there are any abuses in the matter of expense accounts, entertainment?

Mr. STEWART. I have not the slightest doubt that there are abuses.

Senator DOUGLAS. Do you know of any?

Mr. STEWART. Not from personal knowledge.

Senator KERR. Not from personal experience?

Mr. STEWART. Sir?

Senator KERR. Not from personal experience?

Mr. STEWART. Not from personal experience; that is right, sir.

Senator DOUGLAS. Do you have any general impressions as to the nature of the abuses which might exist?

Mr. STEWART. Well, I have read the Commissioner's memorandum which I am sure is a factual memorandum, so that I have access to that knowledge.

Senator DOUGLAS. Your only knowledge on this subject is derived from reading the memorandum of the Commissioner?

Mr. STEWART. In terms of making a study of the problem, in terms of organized information, that is correct, sir.

Senator DOUGLAS. You know of no fields from personal experience or general reading which seem to you questionable?

Mr. STEWART. As I say, I would concur that in those areas which the Commissioner has identified there not only are potential abuses but undoubtedly there are such abuses in fact.

Senator DOUGLAS. What would you do to remedy them?

Mr. STEWART. I would explore, first, whether, as a practical matter, this new legislation is necessary.

Let me give you an example, Senator, as to why we make this observation, which is not made in the spirit of being obstructionists but in terms of getting this job done.

There has been a good deal said about the Cohan rule. The impression we get from the standpoint of documentation is that the Cohan rule, even though it is on the books, does not represent a substantial burden to the Internal Revenue Service in requiring documentation.

Indeed, we are told by auditors of individual companies that they are being asked for and are furnishing and are pleased to furnish rather complete documentation, and that the broad problem of having to accept estimates, which is supposed to be attributed to the Cohan rule, is not, as a practical matter, very serious. This is the kind of an approach to this matter that we are suggesting be explored further.

Senator DOUGLAS. I take it you do not think the test as to whether entertainment, amusement, recreation is directly related to the active conduct of a taxpayer's trade or business, that that should not be retained; that the entertainment, amusement, and recreation be directly related to the active conduct of the business?

Mr. STEWART. No, I think you draw more than we intend by that statement. I think we feel that that kind of a standard which you have read, sir, together with the standards which read like this, "more than a general expectation of deriving some income at some indefinite future time," circumstances which are of a type generally considered to be conducive to a business discussion are standards which are not going to give the agent much more meaningful direction than he has under his present authority, which is the authority that we suggest that we reexamine in terms of the need for the proposed law.

Senator DOUGLAS. Do you believe that general so-called goodwill expenditures in the field of entertainment and the rest should not be restricted?

Mr. STEWART. We do not say they should not be restricted, sir. We believe they are being restricted in administrative practice currently, and that the reasonableness rule is clearly being implied. But we do not believe that goodwill expenditures should be flatly denied. I should add, sir——

Senator DOUGLAS. $50 tickets to "My Fair Lady" would be a proper goodwill expenditure?

Mr. STEWART. Under certain circumstances I would not.

Senator DOUGLAS. The expenditure of $1,000 for a dinner at the 21 Club, would that be a proper expenditure?

Mr. STEWART. That kind of an expenditure is already subject to very thorough scrutiny by the Internal Revenue Service. I think they would answer that question by saying that they would look at that hard under all the circumstances, and in many cases would disallow it.

Senator DOUGLAS. But suppose the claim is made that this is necessary to build up goodwill so that a prospective buyer will buy. How do you disprove that under the present wording of the law?

Mr. STEWART. It is a difficult problem to administer, sir. But the law, the tax law, is full of tight, fine distinctions, and I do not think what the bill is proposing here is going to improve the situation.

Senator DOUGLAS. I cited yesterday some yacht cases, I have many more. One of the cases, of course, involves the claim of a $251,000 expenditure for the purchase of a yacht to entertain people off the coast of Florida. That was allowed by the Tax Court. You think that is proper?

Mr. STEWART. I think there is very grave danger in such a situation that there is an abuse. I think that, again, it is not outside the realm of possibility that such cases can and are being dealt with even though in a particular set of circumstances it was allowed by the Tax Court. I call your attention, Senator, to the fact that the return now calls for identification of the existence of such so-called facilities, and I am sure the Revenue Service is not asking this merely for general information purposes.

Senator DOUGLAS. Well, in suits which they brought in the past before the Tax Court the Service quite generally lost in these matters.

Let us take another case.

Mr. STEWART. Senator, may I interpose at that point this comment? We do not wish to imply by this testimony that it is impossible for or improper for the law to draw certain lines to deal with extreme cases, if the Congress is satisfied that the administration cannot handle them.

But we feel that this bill goes much further than the so-called "horror" cases to which you refer.

Senator DOUGLAS. Well, I am trying to work out your attitude in this matter.

There is another case of a man who manufactured sneakers.

Senator KERR. Manufactured what?

Senator DOUGLAS. Sneakers, tennis shoes, and he had a yacht off Florida and he entertained people, and he was asked what connection does this have with his business, and he said, "Well, I wanted to demonstrate that my sneakers would not skid."

I do not know whether every guest was compelled to put on a pair of his sneakers which he sold or whether there were indentations in the rubber or not. But would you regard that as a ——

Mr. STEWART. If I were an agent I would have questioned that, I would have attacked it, and if I could not handle it under present law I would be unhappy about it.

But I do not believe, Senator, it is necessary to enact these provisions to solve this narrow problem.

Senator DOUGLAS. Just as a matter of record, the claim for exemption was upheld on the grounds that this was a necessary business expense.

Mr. STEWART. Well, sir, we are not in complete disagreement and, perhaps, you missed the implication of my comment.

I am admitting the possibility that in the extreme case like that, if the Revenue Service can document the fact that they do not have in the typical situation such as the one you describe, sufficient authority under the law, that undoubtedly some language could be written which will deal with those extreme situations.

We point out in this testimony, however, sir, that the bill is using a "dragnet" to accomplish a problem which we think is much narrower than the language here will sweep in. We feel that there are many legitimate expenditures contrasted with the types to which you now refer that would be outlawed by these provisions.

Now, that is really the thrust of our testimony.

Senator DOUGLAS. Well, now, let us see, you do feel there are abuses?

Mr. STEWART. I agree there are abuses, although I have no personal documentation of them.

Senator DOUGLAS. The Senator from Oklahoma asked you to prepare a memorandum on abuses so far as investments of Americans are concerned abroad. Can you prepare a memorandum on abuses which you believe exist in the field of entertainment expenses and gifts and the like, and make suggestions for dealing with them?

Mr. STEWART. Well, I do not want to be evasive, Senator. I have no particular personal knowledge of this area. I can write you a general comment as to the types of problems——

Senator DOUGLAS. You are making suggestions here, and we are very anxious to get your constructive suggestions.

Mr. STEWART. Very well, we will endeavor to present you with anything we can contribute in this area. I do not know how helpful it will be.

Senator KERR. Will the Senator yield?

Senator DOUGLAS. Temporarily.

Senator KERR. I want to join the Senator in the request of the witness, who is escorted here by what we assume to be a technician and an expert, in giving the committee your suggestions as to how to eliminate these abuses which the Senator has described and which are well known, and the witness has indicated he feels exist in the matter of expenses, goodwill, business expenses, and so forth, sought to be charged off by the taxpayer.

Mr. STEWART. I want to leave this subject, if the chairman pleases, on the note that I think that the area of abuse is exaggerated and, secondly, that the remedies contained in the bill will not solve the problem but will create additional problems.

We will attempt to submit a memorandum which will be constructive, as you and Senator Douglas have suggested, but I want to be clear in terms of my position on the matter.

(The information referred to follows:)

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., April 13, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During our testimony on April 4 before this committee on H.R. 10650, Senator Douglas requested us to:

1. Identify tax abuses under those provisions of the Internal Revenue Code governing the deductibility for tax purposes of travel and entertainment expenses incurred for business purposes; and
2. Submit any suggestions the institute may have as to how such abuses might be overcome.

This letter is an effort to respond to Senator Douglas' request.

As we indicated in our letter of April 11 concerning abuses in the foreign earnings area, our experience respecting such problems is limited. The institute has made no special study in this area. The definition of an "abuse" in the field of travel and entertainment expense deductibility involves the same measure of subjective judgment that is required in determining abuses in the foreign earnings area. However, upon the basis of Treasury exhibits introduced during these hearings we are inclined to believe that there are some abuses or some enforcement problems in the deduction of travel and entertainment expenses. It is our impression that such abuses are most likely to be found in the following categories of business expense:

1. Business gifts.

   Comment. Business itself has felt that the practice of giving business gifts—and particularly those of an extravagant nature—is generally undesirable, tending in some cases perhaps toward a form of commercial bribery. To our knowledge many companies have made it a practice in recent years to inform all suppliers that company employees are not authorized to accept business gifts of any description. This practice, instituted on industry's own initiative, is becoming so general that the abuse problem is being exaggerated from Government's standpoint.

2. Personal expenses claimed as business travel and entertainment expense.

   Comment. It is our impression that certain excesses have probably occurred in this area. We should point out that such abuses seem to us to be more prevalent and possibly more difficult of detection where the beneficiary of the expenditure has complete or partial control of the company in question. We should add that close auditing by the great majority of companies with which we are familiar narrows the problem area greatly.

3. Entertainment facilities used partly for business and partly for personal purposes.

Comment. We do not mean to condemn generally the possession and use by a taxpayer of facilities which may be used in part for recreational purposes and which are in fact employed in the active conduct of a trade or business. For example, it is common in capital goods marketing for prospective customers to visit a manufacturer's plant for a number of days in order to observe the product in operation. Many capital goods manufacturers are located in small towns or cities where there are few if any recreational facilities, and, indeed, inadequate lodging facilities. To overcome this deficiency, many capital goods manufacturers have built or remodeled guest houses, small hotels, lakeside cottages, etc., for the express purpose of housing and entertaining customers who may visit their plants. This, it seems to us, is an altogether proper business expense.

The difficulty of distinguishing the proper from the improper type of expenditure in this area is only one of many similar problems that must necessarily confront enforcement officials. Moreover, we have some serious question as to whether the present provisions of H.R. 10650 will cure completely these abuses without working substantial injustice by disallowance of necessary business expenses.

SOME DIFFICULTIES WITH LEGISLATIVE TESTS

As we indicated in our statement filed with this committee on April 4, travel and entertainment expenditures are highly individual transactions which can be adjudged "ordinary and necessary" business expenses under section 162 of the code only in the light of all the surrounding circumstances. If there are abuses—and it seems probable that there have been—then something more would seem to be needed by way either of standards for determining the existence of abuses or methods of enforcement—or both—to prevent abuse on the one hand or injustice on the other. In attempting to draw the line, and it is a sometimes indistinct line which separates these two results, the Ways and Means Committee has set out in H.R. 10650 both new tests and new requirements. Entertainment expenses are made wholly unallowable—with certain exceptions—only to the extent the taxpayer establishes that such expenses are "directly related to the active conduct of his trade or business."

It will be conceded we think that the "directly related" test is a most inexact one. Moreover, the explanation of it in the committee report sheds little or no light on its intended meaning or its application in practice. The report, speaking of the "directly related" test, declares:

"This means that the taxpayer must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law. Among other things he will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure; however, he will not be required to show that income actually resulted from each and every expenditure for which a deduction is claimed."

This explanation seems to march up the hill and right back down again. Yet, we have considerable sympathy with anyone who attempts to establish a rule for general application to the almost infinitely varying circumstances of business travel and entertainment expenditures.

The "primary use" rule, under which expenses connected with the maintenance of a facility used for the entertainment of business guests would be deductible only to the extent that more than one-half of the facility's use is for business entertaining, although in part susceptible of application by objective standards, is apt to produce as much disagreement between taxpayer and agent as the "directly related" test. Moreover, as we have observed in our principal statement, we see no justification whatever for the arbitrary rule which would disallow all expenses connected with the maintenance of such a facility if the use of such facility for business purposes falls below 50 percent of the total usage.

In addition, the bill now before the committee, H.R. 10650, makes still a further attempt to establish a general standard for the allowance or disallowance of entertainment expense. "Business meals" may be allowed but only when food or drink is furnished to a customer "under circumstances which * * * are of a type generally considered to be conducive to a business discussion." How does one determine whether circumstances are of a type "generally considered to be conducive to a business discussion"? And considered by whom: The agent or the taxpayer?

Again, we are aware of the difficulty connected with attempting to establish any rule of general application in this area. But, as in the case of the "directly related" test, we suggest that this rule may prove altogether unworkable in practice.

Indeed, the prescription of such standards by statute is, in our judgment, a mistake which proceeds from an understandable but unrealistic philosophy. The travel and entertainment expense provisions of H.R. 10650 seem to rest upon a philosophy which seeks to achieve perfect equity between a taxpayer whose occupation requires business travel and entertainment of customers and a taxpayer whose occupation requires neither. We suggest that such differences of this character as exist by reason of occupational variety will always exist and that it is impossible for the tax system to achieve perfect equity as between taxpayers so dissimilarly situated.

This difference can best be illustrated by an example. It can scarcely be denied that legitimate business travel abroad produces some personal pleasure for persons so traveling. If we pursue this philosophy to its logical conclusion, the next step would seem to be to affix valuations to such personal satisfactions and to require their inclusion in the personal tax returns of individuals involved. Obviously, this would be unworkable, but it illustrates, we think, the thicket of subjective judgments—and the endless burden of administration—into which the proposed travel and entertainment expense provisions of H.R. 10650 are heading.

A SUGGESTION

We think that the current attempt to overcome abuses of travel and entertainment expenses through comprehensive legislation may give rise to an intolerable burden of administration and may be more, rather than less, productive of misunderstandings and quarrels between agent and taxpayer.

May we suggest that the emphasis should be shifted from an attempt to write legislative standards for allowing business expense deductions and that more attention be given to the enforcement area. It would seem to us that the general standard of "ordinary and necessary" is still sufficient for determining allowability or unallowability, and that its very generality permits a nicety of discrimination in enforcement which would not, in our judgment, be possible under H.R. 10650.

We declared in our prior statement that we doubted if the Cohan rule represented as much of an obstacle to enforcement as the Internal Revenue Service has suggested. We continue to believe this to be true of the opinion in the Cohan case as written by Judge Learned Hand, although we acknowledge that there is some case law which may have inappropriately enlarged the Cohan doctrine so as to make it a handicap to enforcement. Under these circumstances, Congress may feel that repeal of the Cohan rule is necessary. Such a step—subject to some appropriate deminimus rule—would clearly provide the Internal Revenue Service with sufficient authority under the present statute to undertake an appropriate policing of the whole area without further legislative changes.

In concluding we should like to reiterate one observation made in our principal statement. These provisions of H.R. 10650 seem to proceed in part from the theory that business has neither any real desire nor any adequate system to control expenses of this character. Insofar as the companies which we represent are concerned, we think any such theory is wholly fallacious.

This completes our comments in response to Senator Douglas' request. We hope they may prove helpful to the committee and we appreciate the opportunity of submitting them.

Respectfully,

CHARLES W. STEWART, *President.*

Senator DOUGLAS. I am not certain that I have mastered all of the contents of your memorandum, and I regret I was not present at the earlier part of your testimony.

Do you take any stand on section 3; so-called lobbying section?

Mr. STEWART. No, sir; we do not.

Senator DOUGLAS. Do you object to section 3?

Mr. STEWART. We have no comment on section 3.

Senator DOUGLAS. Then you do not object to it?

Mr. STEWART. Is that the lobbying expense section?

Senator DOUGLAS. Yes, lobbying, section 3.

Mr. STEWART. We have no comment and wish to enter no objection or approval.

Senator DOUGLAS. Thank you.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. I was not here when the gentleman gave his testimony so I feel that I cannot question him effectively.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I have one or two questions. I hope I am not oversimplifying.

In your opinion, if the House bill should become law, and speaking of the tax on foreign income, would it encourage or discourage the establishment of the plants abroad by American companies, either as branches or as subsidiaries?

Mr. STEWART. There would be some discouragement in situations where the decision is a close one, and where, when all the factors that enter into an investment abroad decision are arrayed, the decision is so close that a change in the picture as to any one of those factors might affect the situation. So to that extent, in my judgment, there would be some situations, particularly as to underdeveloped countries, where a decision might fall on the negative side in terms of investment abroad in the face of the enactment of the provisions.

But I would like to go one step further. The more important impact will be on the ability of companies to remain competitive abroad in terms of their competitive relationships. Their ability to accumulate capital in order to be dynamic companies abroad, and to compete effectively, will be seriously impaired.

I do not believe that a tremendous number of investment decisions to go abroad will be affected, which is another reason why I do not believe the salutary results attributed to this bill will flow. That is the best answer I can give you, Senator Curtis.

Senator CURTIS. Even if it encouraged the establishment of foreign branches, of foreign subsidiaries, or made more competitive, as you say, those already existing, that does not follow that you have less business here, does it?

Mr. STEWART. No, no.

Senator CURTIS. Suppose there is, and this is hypothetical, suppose there is a country where there is a market to be filled if somebody goes there and builds a plant, and that plant might be built by German interests, it might be built by British interests or it might be built by interests in the United States.

Would you say that whoever establishes the plant there will have set the pattern for considerable exports to that place, assuming the business succeeds in the years to follow?

Mr. STEWART. Our experience indicates the answer is clearly affirmative, and importantly so.

Senator CURTIS. It sort of establishes the pattern or the channel of trade, does it not?

Mr. STEWART. Not only that, in the capital goods business, Senator, as you may know, the jump on the competitor is terribly important. When you are building a steel mill, for example, you do not build one every week. Once the establishment of a commercial relationship with third markets is built, it stays put for quite a while.

We are not dealing here with the theoretics of statistics that are contained in exhibit III, as wrong as we think some of them are We are dealing with practical business considerations such as the ones you referred to.

Senator CURTIS. But it is a fact that once the plant is established in a given foreign country, the tendency for personnel and supplies and repairs, financing, component parts, insurance transactions, and everything are very much more inclined to flow from the country that established the plant than from other countries; isn't that correct?

Mr. STEWART. I do not think there is the slightest doubt about it, but not necessarily and not in most cases to the conclusion of or in competition with exports from the United States. Because in most cases the company would not have gone into this area if it could have operated effectively with respect to other markets from the home base.

Senator CURTIS. Now, in the overall, the establishment of plants in foreign lands by American companies, has that increased or decreased the employment that we have offered at home? I realize there will be isolated cases or maybe not necessarily isolated, but certain classes of cases where it might be true. But in the overall, what is your opinion?

Mr. STEWART. I think that, in the first place, the job opportunities which are related at home to exports from the United States which follow investment abroad, are important in many, many companies.

I think also that there are many companies, and we saw this in the last recession, that maintained dynamism within their organizations through earnings made available to them abroad, through ideas which came, in part, from abroad, as well as from home, which enabled them to carry research and development and key people through very difficult times when they might not have been able to do so if they had not had foreign operations.

This is another aspect of this problem that is not necessarily so high in numbers as it is in key people. Research and development people come expensive, and outstanding ones come very few and far between.

We know of companies in the institute that suffered very bad times during the recession, and practically lived off of their foreign operations in terms of their domestic base. This is just as important as saying that we employ, as I know one company does, an entire plant in Pennsylvania which is involved in shipping mining machinery parts to a plant in Scotland. They are both important to the health of the domestic base.

Senator CURTIS. You hear the expression exporting jobs, but do we have two classes of problems here or cases, rather, one, where the American company goes abroad and builds a plant to serve a foreign market, and that is the only way they can do it competitively; and that, I gather from your testimony, you would want to encourage?

Mr. STEWART. Precisely.

Senator CURTIS. And that will increase our exports?

Mr. STEWART. And our total industrial strength as a nation, which we believe is a world-minded nation, from everything that the President and others tell us in this administration, and which we believe.

Senator CURTIS. That is one category.

There may be another category of businesses that abandon their home base in the United States and go abroad because they cannot make a go of it here, and may or may not send imports back into this

country. But that class, category, are not very much or primarily involved in these proposals which are proposals for a tax on foreign income, are they?

Mr. STEWART. No, I would not say they are involved, and in terms of our experience with capital goods there are few such companies.

If this result occurs so that such movements do take place, I would suggest that there are some other aspects of our economic climate we might examine in order to determine the situation which brought that about, recognizing, of course, that some businesses fail, I regret to say so, because they should.

Senator CURTIS. Well, I am thinking of one that had excellent management, a good management, as good as they could have. We have a jewel watch industry in Nebraska that employed up to 2,000 people. It is now in Japan.

I do not believe that had the provisions of the House bill with respect to tax on foreign income been the law back when that happened it would have prevented it because of these other factors.

Mr. STEWART. Precisely, and I referred to those, Senator, before you came in.

Senator CURTIS. So you do not regard the enactment of the provisions of the House bill on foreign income as an effective means of holding jobs in the United States that we are going to lose?

Mr. STEWART. Not in any substantial way whatsoever. I think it is an illusion.

Senator CURTIS. Is that the reason why certain leaders in labor are favoring it?

Mr. STEWART. I cannot speak for them, but I would suspect so, and I think they are mistaken.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Morton?

Senator MORTON. Mr. Stewart, developing a little further the colloquy with Senator Curtis, and then one or two other points and I shall attempt to be brief, first, how many members are there in your organization?

Mr. STEWART. We are an organization made up really of two parts. We are a federation of trade associations, so that in one respect our relationship is with some 30-odd individual trade associations.

In addition we work with some 420 individual companies.

Senator MORTON. Those 420-odd individual companies, how many roughly would you say have foreign subsidiaries?

Mr. STEWART. We have not surveyed them. May I ask one of my associates? What would you guess, based on the international operations?

Roughly 20 percent, and they may be very minor in size ranging to multiple plants and very large in size.

Senator MORTON. If, without violating their confidence, and if it would not be too herculean a task, it might be interesting if we could have the exports of those, of those 20 percent, which have foreign-owned subsidiaries over the years, with a rough idea of their investment abroad.

I say this because I have the impression that their exports from this country, from their own plants in this country, have not diminished as a result of their investments abroad.

I do not know that in the confidence of the business community you could develop that, but I think any information you could develop along that line would be informative.

Mr. STEWART. We will furnish the committee whatever information in response to that which we can, sir.

(To obtain the information requested will require making a special survey of the members which will necessarily take about 2 or 3 weeks to complete. If this survey can be completed prior to the printing of the last volume of these hearings it will be inserted therein.)

Senator MORTON. Now, you talked to the point of constitutionality which we have dealt with in a rather cursory manner this morning.

I happen to be one of those rare Members of this body who is a businessman and not a lawyer. Sometimes I think the United States would be better off if we were more of us and fewer lawyers here. [Laughter.]

As I see the situation in my lay mind, it is comparable to this: Let us suppose that a trucking company in Kentucky had 10 stockholders. Five lived in Tennessee and five in Kentucky.

Let us assume that they made $100,000 after taxes in 1 year. They decided they would pay $25,000 in dividends, that they would retain $75,000 in the business for the purpose of buying new trucks and expanding their operations.

The State of Tennessee has an income tax law. The State of Tennessee would say to those five Tennessee stockholders—

but you must pay an income tax based on the earnings of this Kentucky corporation in which you own stock in the amount of four times what you paid because they earned $100,000 and they only paid $25,000 in dividends.

Admitting that is an oversimplification, is that not to a lay point of view somewhat analogous to this constitutional question?

Mr. STEWART. I think you are a much better lawyer than you admit, sir.

I would say that you draw a point here that worries me beyond the scope of this bill.

It seems to me we are breaking new ground if we go to the full route of these provisions in terms of applying the same principle to our domestic tax policy. I am quite concerned about it, and your example is completely on the beam in that respect.

Senator MORTON. Well, now, getting back to this matter that Senator Curtis touched upon, the export of jobs, the President on December 7 of last year, in addressing the AFL–CIO convention, said that the export of private capital means the export of jobs.

I take it from your testimony that you are not in full accord with that statement?

Mr. STEWART. I think it is in error, sir, respectfully, oversimplification.

Senator MORTON. It is one of the cases in which I happen to disagree with the President, too.

Now, granting that he is perfectly sincere in his conviction and in his statement, which I accept and believe him to be, although I do not agree with it, how can we differentiate between the export of private capital, as he puts it, and if that causes the export of jobs, what about investments that follow by the World Bank, the International Development Association, the Inter-American Bank, the AID agen-

cy, to which we make massive contributions of capital? Could that also not be construed as an export of jobs if the export of private capital is an export of private jobs?

Mr. STEWART. I think without question, Senator, that you are bearing down on a point which bothers me in terms of the Government philosophy that is involved here.

We take a worldwide, broadminded, liberal attitude toward world trade when we work through the International Bank, when we developed the Alliance for Progress, when we work within NATO, when we consider H.R. 9900.

But when we come to foreign earnings, we sound like isolationists.

I think there is unquestionably truth in your suggestion that unless we are prepared as a nation to withdraw from international assistance and international investment completely, there is always the possibility somewhere along the line of aiding competition aboard and affecting somewhere along the line our domestic base.

I would agree with you 100 percent. I am sure this administration, however, does not want to withdraw from the programs you ticked off, nor does this administration want to withdraw from H.R. 9900.

I was surprised this morning to find that the witness, who I am sure would support H.R. 9900, and Senator Gore, in examining him, expressed great concern about the possibility of imports from foreign based companies, which possibility, incidentally, I do not think has reached any proportions that we need be concerned about. But, at the same time, we are considering as a nation H.R. 9900 as a philosophy of foreign trade. Are we to frown on imports which might arise within reasonable limits from foreign based companies? How do we reconcile those two philosophies? I cannot.

Furthermore, if this country approaches the Common Market problem from the standpoint of breaking down trade barriers through the enactment of legislation like H.R. 9900, would the labor movement and would the Congress of the United States, rather, have imports come from U.S. subsidiaries overseas or from foreign competitors?

Senator MORTON. I think you make a good point there when you say you find difficulty in reconciling these apparently antithetical approaches to a common basic problem.

I assume you can sympathize with us who are asked here to sympathize with the program which would discourage private investments in developed countries abroad and, at the same time, to support a program of which I have been long a supporter of its predecessor, such as H.R. 9900, and when I was a member of the former administration I twice had the responsibility of guiding that bill through the Congress; I once saved it from recommittal by only one vote in the House, and that in Kentucky we call a photofinish, and also I have been, since its inception, a supporter of the so-called foreign aid program.

I am also a supporter of the present AID program and all of its predecessors back to the Marshall plan.

Now, I am being asked to, it seems to me, put myself in a completely contradictory position in this attack, as I see it, on those companies which, for competitive reasons, not for tax reasons, but for their own survival in foreign markets or to gain foreign markets, have built or are contemplating plants abroad.

I cannot see for 1 minute—I agree with what you said—that in response to a question from either Senator Kerr or Senator Curtis that if these provisions, especially the administration's suggestion, is adopted into law, it might in a tightly balanced case determine whether or not company X starts a subsidiary abroad.

But I am thinking of the billions that are invested abroad today, what they do for U.S. exports, first; what they do, secondly, in bringing dollar earnings to this country far in excess of the capital dollars that are going out.

Mr. STEWART. I could not agree with you more, Senator.

Senator MORTON. And I think we are dealing with a problem here that can well tailspin us into a real recession, can really jeopardize job opportunities in this country, by taking this insular, isolationist position on investments abroad.

I want to congratulate you, sir, on an excellent statement.

Mr. STEWART. Thank you, sir.

The CHAIRMAN. Thank you very much, Mr. Stewart.

Mr. STEWART. Thank you, sir.

(The prepared statement by Mr. Stewart, together with the appendix, follow:)

STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE ON THE PROPOSED "REVENUE ACT OF 1962" (H.R. 10650) BY CHARLES W. STEWART, PRESIDENT, ACCOMPANIED BY GEORGE TERBOROGH, RESEARCH DIRECTOR

Mr. Chairman and gentlemen, it is a privilege to appear before the Committee on Finance as president of the Machinery and Allied Products Institute and chairman of the institute's affiliate organization the Council for Technological Advancement. These organizations represent capital goods and allied product industries of the United States and are engaged in economic and management research with particular emphasis on the supply of capital funds, capital investment, and technological advance.

Our written statement, which is before the committee, is respectfully submitted for the record. Because of time limits the oral presentation will be addressed to portions of the statement and to certain supplemental points which deserve emphasis. The institute would also appreciate the opportunity to file a supplemental statement for the record in the event this proves desirable in order to give adequate treatment to the complex and significant subject matter involved.

First, may we deal with the subject of section 2 of the bill relating to the proposed investment credit.

CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY (SEC. 2)

I should like to make it clear at the outset that the Machinery & Allied Products Institute renews its endorsement of the proposed investment credit concept [1] as a permanent part of our tax law. Though the incentive effect provided for by section 2 of H.R. 10650 is less than we would like, it is at least a start on an urgent national problem—the need to improve the U.S. rate of economic growth.

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[1] In its original testimony before the Committee on Ways and Means on May 12, 1961, the institute applauded the President's initiative in sponsoring an investment incentive, subject to the reservation that it must not be considered a substitute for either the reform of tax depreciation or overall tax reform. However, MAPI in that testimony opposed the 3-bracket-and-floor arrangement as complicated and inequitable, and urged that if the credit approach is followed the credit should be made applicable at a flat rate, preferably not less than 10 percent, to all eligible investment regardless of its relation to the taxpayer's depreciation. Subsequently, in response to the invitation of the Ways and Means Committee for public comment on the committee draft bill released on Aug. 24, 1961, the institute in a letter to the committee dated Jan. 16, 1962, registered its support for the 8-percent flat-rate investment incentive credit contained in that bill.

General comments

Secretary Dillon's testimony on Monday recommended that the Finance Committee restore the credit to 8 percent, the original level reported by the Ways and Means Committee. This was accompanied by a recommendation that the Finance Committee restore the limitation on amounts over $25,000 to the 50-percent figure originally adopted by the House committee. We, of course, defer to the Senate Finance Committee with respect to overall fiscal judgments, but, in terms of the objectives of the credit and the optimum level of its operation, we join the Secretary in this recommendation.

As we shall develop in more detail later in this section of our testimony on the pending bill, the institute does not consider the credit a subsidy, a loophole, or a gimmick, as some have charged. Moreover, as the Secretary of the Treasury emphasized on Monday, we feel the stimulative impact of the credit on sound investment would be substantial.

One final preliminary comment. In appearing before the Committee on Finance in support of the investment credit approach, we should like to call attention to the fact that certain representations which have been made to the effect that the business community as a whole opposes the credit are inaccurate. There is a difference of opinion within business on this subject, but MAPI and a number of organizations, which either will testify before this committee or have otherwise made their views public, favor the enactment of an investment credit provision.

The problem of economic growth

As suggested above, the need to improve our less than satisfactory rate of economic growth is an urgent national problem. To document this problem we rely on original economic research conducted by the institute, to which the Secretary of the Treasury referred in his presentation to this committee.

Most of the leading industrial countries of the West have done better in recent years than we have, as have, apparently, most of the Communist countries. I can illustrate this statement for the Western countries by the following table, which ranks them in the order of their economic growth rates over the decade of the fifties. The measure of growth for this purpose is the average annual increase in gross national product at constant prices:

Average annual growth, 1950–60

[Percent]

Country	Percent	Country	Percent
Japan (1953–60)	8.5	Switzerland (1954–60)	4.8
Germany	7.5	Canada	3.7
Austria	5.9	Sweden	3.5
Italy	5.8	Belgium	3.1
Netherlands	4.7	United States	3.0
France	4.6	United Kingdom	2.6

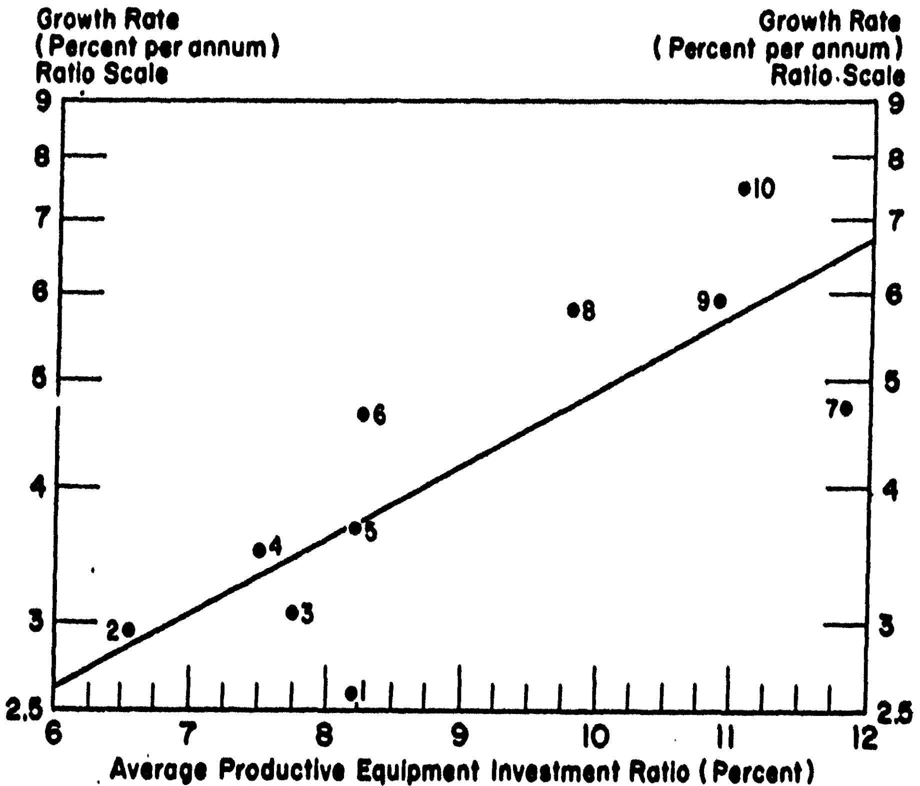
While the quality of the statistics behind this ranking does not justify a precise reading of the results, it is evident after all due allowances that the United States does not make a good showing. In baseball terms, it is "near the cellar."

There are many factors underlying these disparate growth rates, but it is our belief the most important is differences in productive investment ratios—ratios of productive investment to gross national product. This belief is supported by the chart on the following page, which shows for 10 countries the relation between the economic growth rate and the percentage of gross national product invested in productive equipment during the decade of the fifties.

Here a positive correlation between growth rates and investment ratios is clearly visible. At the investment ratio of the United States, the line of average relationship indicates a rise of 0.49 of a percentage point in the growth rate for a 1-percentage-point increase in the ratio. Stated otherwise, an increase of equipment investment by 1 percent of the gross national product is associated with an increase of 0.49 of a percentage point in the annual growth rate of that product itself.

It will be noted that in terms of its productive-equipment investment ratio, the United States is at the bottom of the list. It has been living on a starvation diet of productive capital formation. There can be no doubt, in our opinion, that this is a major factor in its relatively unfavorable growth rate. It has been enjoying the luxury of a high-consumption economy while its competitors have outsaved and outinvested it, and is paying the penalty of this opportunism.

Average Annual Increase of Gross National Product at Constant Prices, in Relation to the Average Ratio of Productive Equipment Investment to Gross National Product[a]



[a] Key: 1. United Kingdom; 2. United States; 3. Belgium; 4. Sweden; 5. Canada; 6. France; 7. Netherlands; 8. Italy; 9. Austria; 10. Germany.

Average annual growth for the 10-year period 1950-60 is related to the average investment ratio for the 10 years 1950-59, inclusive. Again investment is gross (before depreciation). It includes productive equipment bought by governments and government enterprises, but excludes such equipment used for military purposes. The comparison is not available for Japan and Switzerland.

The situation is aggravated by the prospect (now only 2 or 3 years away) of a greatly increased growth rate of the labor force. This will absorb large amounts of investment merely in equipping the added workers with existing technology, leaving that much less for increasing the investment per worker throughout the economy, and hence per-worker output. Like the Red Queen, this country will have to run faster to stay in the same place.[2]

Investment incentives abroad

One reason for the more favorable productive investment ratios in other countries is the widespread and growing use of investment incentives. These have taken a variety of forms—high rates for regular depreciation, short service lives, initial writeoffs, investment allowances, etc.—but they have had the common effect of saving or deferring taxes and thus augmenting available investment funds. It is the need to augment available investment funds in the United States that is central to improving our productive equipment ratio and in turn our economic growth.

The effect of these incentive devices is indicated in the chart on the following page, which shows for the United States and seven foreign countries the capital consumption allowances available in the first year and the first 3 years of service of an asset given a 15-year life for tax purposes.

The chart presents a striking picture. In two of these countries the first-year writeoff exceeds 50 percent of cost. In two more it exceeds 30 percent. The corresponding figure for the United States is 13 percent. Two countries permit a recovery of more than 70 percent of cost in the first 3 years of service, and two more allow over 60 percent. The American equivalent is 35 percent.[3]

We observed in testimony on the Revenue Act of 1954 that the United States had then the worst tax depreciation system of any major industrial country in the world. That act, which authorized the use of either double-rate declining-balance or sum-of-digits depreciation on thereafter-acquired assets, went far to correct this situation. For the moment we were more or less abreast of the procession. Since then, however, we have stayed put, while other countries have moved on. It is obvious that once again we are near the tail end of the procession. It is against this background that the pending tax credit should be considered.

The references which we have just made to deficiency in tax depreciation in the United States prompt this comment as to the relationship between depreciation reform and the initiation of a tax credit approach. The two are not mutually exclusive, as pointed out by Secretary Dillon in his current testimony and in his presentation on January 18, 1962, to the Joint Committee on Internal Revenue Taxation. Indeed, the administration has chosen to adopt a two-pronged approach involving recommended statutory enactment of an investment credit and reform of the length and classification of useful lives of depreciable assets as contained in the so-called Bulletin F. In other words, the administration views these two approaches as complemenatry.

It should be added that in terms of the end objective we are concerned with economic growth and the relationship of capital investment to economic growth. As a corollary, we are concerned with proper stimulants to sound investment. It is a mistake, in our judgment, to think therefore of depreciation reform and the investment credit as alternatives between which the country as a matter of national policy must choose. In this respect much of the debate in the House of Representatives and some of the criticism directed at the credit miss the point. The two approaches are in fact perfectly complementary, and, as the institute has observed on a number of occasions, neither the Congress, the executive department, nor business itself should reject the credit approach simply because it is novel. If it is sound, and we believe it to be, it should be enacted promptly and dynamically implemented.

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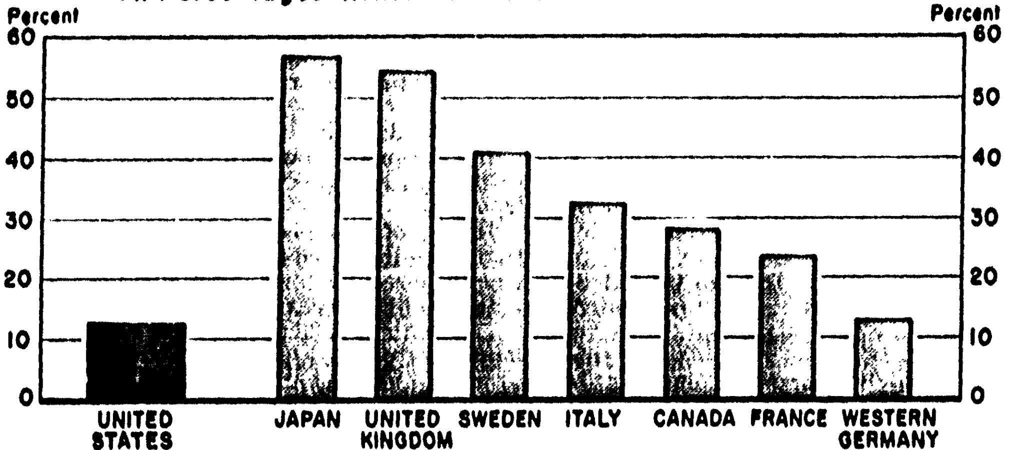
[2] For a fuller treatment of this problem see "Capital Investment and Economic Progress in Leading Industrial Countries, 1950–60," Capital Goods Review No. 48, January 1962, Machinery & Allied Products Institute.

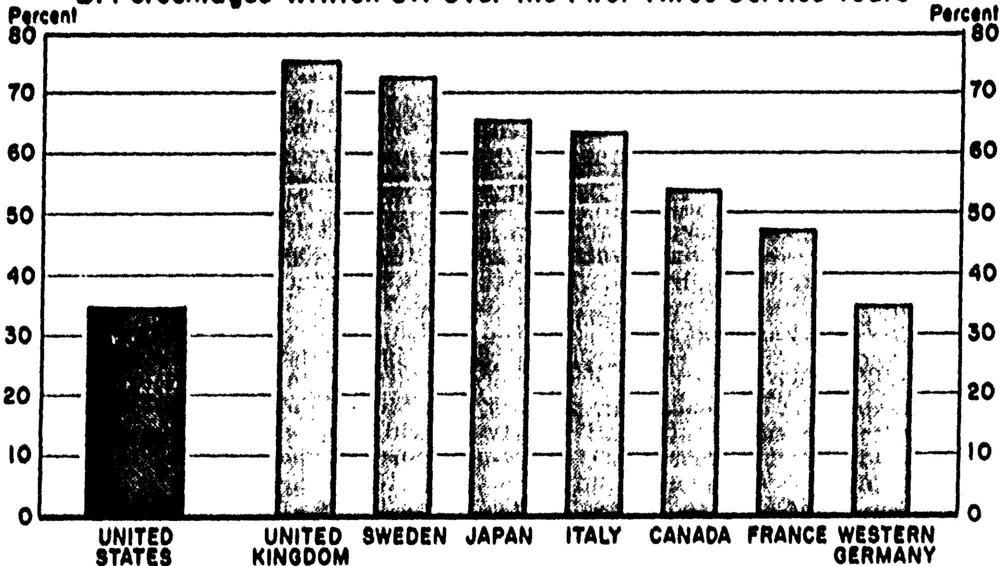
[3] Only one country (West Germany) is in our class, and this one decelerated recently after a period of greater liberality, as a brake on what was deemed excessive investment activity.

Capital Consumption Allowances Obtainable in the United States and in Seven Foreign Countries (1) in the First Year of Service, (2) in the First Three Years of Service, on Equipment Given a 15-Year Life for Tax Purposes[a]

A: Percentages Written Off Over the First Service Year



B: Percentages Written Off Over the First Three Service Years



a/ The chart is from "Tax Depreciation Here and Abroad," Capital Goods Review No. 44, which should be consulted for further details. It presents the picture as of that time, of course, but it would not be materially different today.

General comments on the credit

Opinions differ as to the form an investment incentive should take, and the proposed credit is, of course, only one of several possibilities. It has its advantages and disadvantages, both of which (but particularly the former) are widely misunderstood.

In an attempt to clarify the picture, the institute undertook a comparative analysis of the credit (then 8 percent) and its most common alternative, an initial writeoff of depreciation, the results of which were published in a pamphlet "Incentives to Capital Investment—Two Approaches Compared." Since the pamphlet is being submitted for the committee files I shall offer here only the conclusions, modified for the presently proposed credit of 7 percent as contained in the bill before the committee:

(1) Because it is a direct offset against tax, and does not reduce subsequent depreciation allowances, the proposed 7-percent credit is equivalent to initial writeoffs several times as large. While the equivalence varies with the service life of the assets concerned, for companies subject to the full corporate tax rate it would require at least a 35-percent writeoff to match the credit in average, or overall, terms.

(2) For such companies, the proposed credit is equivalent to a very substantial tax-rate reduction—around 12 percentage points on a 15-year asset, for example. The 35-percent writeoff has in general a comparable impact, again in average terms.

(3) The credit is more favorable to short-lived than to long-lived assets. An initial writeoff, on the other hand, yields virtually uniform benefits over the service-life range.

(4) The writeoff is more favorable to high-rate than to low-rate taxpayers, whereas the credit yields roughly comparable benefits over the tax-rate range.

(5) Even when a writeoff is equivalent to the credit in incentive value, the time pattern of the net tax saving is very different. The writeoff yields a much larger initial gain, offset over the remainder of the service life by net losses. On a flow of investments (as distinguished from a single commitment), the writeoff yields a larger net tax saving than the credit for several years; thereafter it yields less. To put it another way, the tax loss to the Government from the credit is less in the early years as compared with an equivalent writeoff.

One important fact must be remembered in this connection. Regular tax depreciation is so deficient in this country, largely from failure to recognize and allow for the effects of inflation, that an incentive could be very sizable indeed without doing more in an overall sense than merely offsetting the deficiency. Careful estimates of underdepreciation run from $5 billion to $8 billion a year.[4] This means that business is paying $2.5 billion to $4 billion more in taxes annually than it would with adequate depreciation.

Even if we take the lower limit of this range, it would be above anything now contemplated in the way of investment incentives. The proposed 7-percent credit will yield a tax reduction of around $1.5 billion a year at the outset. This would have to be much larger to offset the depreciation deficit. Until this is done, what appears to individual taxpayers as an incentive appears from the national, or overall, standpoint as compensation for underdepreciation. From the national standpoint, an incentive system begins where realistic depreciation leaves off. It goes beyond it. It is no disparagement of the credit to say that it will be some time before we reach this point. Thus, we are not even approaching a subsidy or a loophole by taking the action embodied in section 2 of H.R. 10650.

In summary, we believe that the need for an investment incentive transcends controversy as to its precise form. The proposed credit is a desirable, if limited, step in the right direction.

Detailed comments

1. *Scaled-down for short lives.*—Our first detailed comment on section 2 has to do with the scheme for scaling down the credit at the short end of the service-life range. The scale-down is in recognition of the undoubted fact that a flat-rate credit is relatively more advantageous for short-lived than for long-lived

[4] See "Underdepreciation From Inflation," MAPI Capital Goods Review No. 45, April 1961.

assets, and is therefore correct in principle. The method proposed is, however, unnecessarily crude.

The proposed new section 46(c)(2) grants in effect one-third of the full credit to assets with an estimated useful life of 4 or more but less than 6 years, and two-thirds for assets with a life of 6 or more but less than 8 years. These adjustments not only overcompensate for these short-lived assets; the jumps between the service-life brackets are needlessly wide and abrupt. We suggest as an alternative that for lives under 10 years the taxpayer be allowed a percentage of the full credit equal to 10 times the estimated life. Thus a 4-year asset would receive 40 percent, a 5-year asset 50 percent, and so on. The alternative methods to the scale-down are graphically compared in a MAPI chart of which there is a preliminary copy at the witness table. Multiple copies will be reproduced and filed within a few days, with the permission of the committee.

The treatment we propose is not only superior in theory; by reducing the differences in the credit available for successive service lives it would reduce the need for the recapture provision of section 47(a)(1). There would be less incentive to hold assets beyond the desirable time for disposition in order to get a large abatement of the recapture. I may add that with the scale-down formula proposed it would be possible to extend credit eligibility to 3-year assets, which are eligible for the new depreciation methods provided in section 167 of the 1954 Code.

2. *Recapture provision.*—The proposed section 47(a)(1) provides for the recapture of part of the credit in the case of assets retired before the end of the service life on which the credit was based, where the credit would have been lower if based on the actual life.

One basic difficulty with this recapture provision arises from the nature of service-life estimates. In principle, these are estimates of average life expectancy at installation. Even when this average is correct, there are roughly as many chances that the assets will be retired short of it as there are that it will go beyond it. If the subaverage retirements fall in the scale-down area, they will be subject to a partial recapture of credit even though the average itself is beyond it.

For example, many normal retirements of assets with average life expectancies of 10 to 15 years, or even longer, would fall below the present break point of 8 years, hence would be liable to recapture proceedings. This would give the holders an incentive to delay such retirements beyond the normal time in order to reduce or avoid the recapture—obviously an undesirable effect.

The Treasury is concerned with the possibility that taxpayers may overestimate lives of short-lived assets in order to get into a higher credit bracket. Against this possibility, however, it has adequate remedies without recapture. It can disallow such lives prospectively, if they appear unreasonable, or it can require revision for subsequent applications if experience shows them to be too long. As I pointed out earlier, moreover, the smoother and more gradual scale-down of the credit we recommend would reduce the incentive for abuses. For these reasons we urge the abandonment of the recapture provision entirely. If it is retained in any form, it should at least be at the discretion of the Commissioner, not mandatory, as at present.

3. *Definition of section 38 property.*—There are, in our opinion, three ambiguities in the definition of section 38 property. We will identify the ambiguities and make certain recommendations.

The first has to do with the term "a building and its structural components" which are declared ineligible for the credit under the proposed section 48(a)(1)(B). The language of the bill itself is not clear as to whether "structural components" include or exclude elevators, escalators, central-heating and air-conditioning systems, built-in conveyors, and the like. In view of this uncertainty, it is desirable that the status of such items be clarified.

On the following grounds, we favor making such items section 38 property and therefore eligible for the credit. The explanation of the action of the House Ways and Means Committee as contained in the committee report, which reflects at least in part administration recommendations, indicates that emphasis is placed on equipment and machinery as distinguished from real property because it is believed the need for investment in equipment is the major requirement of the economy. Accordingly, in the definition of section 38 property a building and its structural components are excluded from eligibility. The term "structural components" is interpreted by the technical explanation in the report to include such parts of the building as central air-conditioning and heating systems relating to the operation and maintenance of the building. We feel that structural

components should not be so broadly defined where items like air-conditioning and heating equipment can be demonstrated to be necessary to the business functions referred to in section 48(a)(1)(B)(i).

The second ambiguity concerns the status of "other tangible property" (sec. 48(a)(1)(B)) acquired by firms in trade, service, and finance. These fields of activity are not listed among "manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services." Unless it is intended to exclude these omitted activities, they should be enumerated.

The third ambiguity concerns the meaning of the expression "used as an integral part of" manufacturing, production, etc. What is the status of "other tangible property" used in a manufacturer's warehouse or sales agency? Is selling an "integral part" of the business functions referred to in section 48(a)(1)(B)(i)? What about procurement? Should business functions in 48(a)(1)(B)(i) be broadened to include distribution and procurement? Does section 48(a) draw too fine a line between a research or storage facility immediately adjacent to a manufacturing facility and one which is remote in location but absolutely essential to the distribution process? These questions should be answered. Consistent with the spirit of the House Ways and Means Committee report, we feel they should be dealt with in a liberal, rather than narrow, framework in order to accomplish the ultimate goal of the investment credit; namely, to stimulate capital investment particularly in equipment and machinery.

Summary

We support the investment credit and hope that it will be restored to its original level as first reported by the Ways and Means Committee. It is an important start toward the solution of our problem of economic growth. We hope that the committee acts favorably on the credit and will accompany this action with a recommendation that depreciation reform proceed expeditiously in accordance with the program already outlined by the Secretary of the Treasury. Certain technical problems under the credit provisions as presently drafted should be reviewed and appropriate amendments adopted as we have suggested.

GAIN FROM CERTAIN DISPOSITIONS OF DEPRECIABLE PERSONAL PROPERTY; TREATMENT OF SALVAGE VALUE (SEC. 14)

Moving from the investment credit it is logical to turn to section 14 of the bill, which treats gain from certain dispositions of depreciable personal property and contains an important salvage-value provision.

First, we should like to state briefly our view and then develop certain background for the record. We enter no objection to the withdrawal of capital gains treatment on the disposition of depreciable property when the change is accompanied by the following stipulations as contained in section 14 or as provided for by separate action of the Congress or the Treasury Department: (1) the ordinary income treatment will be limited to the extent of depreciation taken for taxable years beginning after December 31, 1961—there will be no retroactive application of the provision; (2) more liberal treatment of salvage value is accorded; (3) there will be a continued understanding between Congress and the Treasury Department that the administrative program of depreciation reform as announced by the Treasury Department will be carried forward expeditiously; and (4) section 2, the investment credit provision of H.R. 10650, will be enacted in substantially its present form, or with a higher level of impact as recommended by the Treasury Department.

Within this framework there is merit to section 14 of the bill; however, we would like to make it clear that we would not favor enactment of section 14 in the absence of this combination of actions by the Congress and by the Treasury Department.

Now a word of explanation as to why we feel the change in the gain from dispositions of certain depreciable property must necessarily be accompanied by these other provisions or actions. It is true, of course, that section 1231 of the Internal Revenue Code was designed for wartime conditions, and it was not contemplated that it would be fully operative during normal peacetime periods. On the other hand, during a period of demonstrable need for depreciation reform we have always felt that the capital gains privilege offered by section 1231 served at least as a crude compensation for loss in capital recovery from inflation and from generally inadequate depreciation provisions. Government now seems determined to undertake at least partial reform in this area, and this

represents one factor leading us to our conclusion as to the propriety of section 14.

Moreover, section 14 expressly provides for considerably more liberal treatment of salvage value of personal property. It is provider that in determining depreciation the salvage value of an asset may be reduced by up to 10 percent of its cost or other basis, and if this value is less than 10 percent of basis (at the time it is determined) it may be disregarded altogether. Enactment of such a provision would overcome one of the more vexatious aspects of present tax administration. The Treasury Department has long felt that it needed to administer salvage value toughly in the light of the existence of section 1231. At the same time, the taxpayer was apparently confronted in some situations with efforts on the part of the IRS agent to offset depreciation gains resulting from enactment of the 1954 new depreciation methods by an increase in salvage value. This produced an impossible situation, and we are pleased that the Treasury Department is giving support to the salvage provision under discussion.

We referred above to the administrative program of the Treasury Department with respect to the reform of depreciation as to useful lives. This is a welcome step in the long-needed reform of our tax depreciation system. It was undertaken to give due recognition to the rapid progress of our industrial technology and the concomitant march of technological obsolescence, which tend to reduce service lives of productive equipment. As previously suggested in this statement, we have felt that the Congress should expressly recognize the Treasury Department program in this connection and encourage its prompt completion. Ultimately we hope that depreciation reform will encompass the problem of recapture of losses resulting from inflation.

With this background and the framework in which we place our recommendation in mind, the institute supports the change in treatment of gain from certain dispositions of depreciable personal property.

New recommendations as to real property

In his testimony to this committee on April 2, Secretary Dillon made some recommendations with respect to the status of real property in regard to tax treatment of its disposal and also in regard to normal depreciation methods which would be applicable to real property hereafter acquired. As to the latter, the Secretary recommended that depreciation be limited to an amount not in excess of that allowed under the straight-line method. We have not had an opportunity to study this recommendation in detail, but we wish to enter a strong recommendation that the Senate Finance Committee not act on this proposal and that it be deferred until overall tax revision, including the depreciation provisions of the code, is before the Congress. This is a fundamental change in the depreciation system as applied to real property. It is entirely separable from the problem of section 1231 treatment; accordingly, rejection of the depreciation recommendation would not require rejection of section 14 of the bill.

BUSINESS ENTERTAINMENT AND TRAVEL EXPENSES (SEC. 4)

Section 4 of H.R. 10650, which adds new section 274 to the Internal Revenue Code, would disallow "in whole or in part certain expenses which would be fully deductible under present law." It seems clear from the language of section 4 and from the accompanying explanation in the House Ways and Means Committee report that it is intended to establish a much narrower interpretation of those general criteria for business expense deductions which appear in section 162 of the code. The Treasury Department—as indicated in Secretary Dillon's testimony of April 2—would go further and, for example, eliminate completely any allowance for entertainment expense, subject to the nine exceptions contained in proposed section 274(d), as included in H.R. 10650.

We do not believe that the Treasury testimony, including the statement of Secretary Dillon on April 2, makes a conclusive showing that pertinent existing provisions of the code do not in general provide sufficient authority to prevent tax deduction of travel and entertainment expenses that are purely personal in character. The Treasury in recent years has made significant progress toward the elimination of abuses.

For example, changes in the corporate return, form 1120, now require the corporation to list expense account allowances paid to its 25 highest paid officers and to indicate whether or not it has claimed a deduction for expenses connected with automobiles, yachts, hunting lodges, fishing camps, or similar facilities for its employees. Further, we are informed, the Revenue Service in-

the course of audits is requiring more complete documentation of claimed business expense deductions. Also, we understand that under present law revenue agents allocate traveling expenses according to business and personal purposes.

Thus, enforcement has already taken an important forward step in that very area to which Treasury testimony assigns much, if not most, of the alleged abuses. We think these administrative measures should be given a reasonable opportunity to overcome enforcement shortcomings since problems in this area, in the very nature of the case, are and must remain primarily administrative matters.

The Cohan rule

As for the proposal to overrule the so-called Cohan rule, we are inclined to believe that its abolition may create as many—or more—problems than it solves. We suggest that the Cohan rule does not go as far as Treasury testimony intimates. In brief, Cohan holds that a taxpayer may be allowed an expense deduction in a reasonable amount when the evidence indicates that the expense has been incurred but its exact amount cannot be determined. The Cohan rule is scarcely the invitation to improper tax deductions that it is made out to be. Consider the Tax Court's language on the Cohan rule in Richard A. Sutter, 21 T.C. 170 (Acq., 1954-1 Cum. Bull. 6): "* * * we think the presumptive nondeductibility of personal expenses may be overcome by clear and detailed evidence as to each instance that the expenditure in question was different from or in excess of that which would have been made for the taxpayer's personal purposes. Where such evidence is absent we conclude that even under the Cohan rule no amount whatever for such expenses may properly be claimed."

To require complete, or nearly complete, substantiation of travel and entertainment expenses may impose an intolerable burden of administration on both the taxpayer and the Internal Revenue Service.

We repeat our belief that present law contains sufficient authority to remedy any abuses which may exist in the deduction for tax purposes of business travel and entertainment expenses. Nevertheless, if it is the decision of the Congress to legislate further in this area, we have a number of suggestions to make respecting the provisions of section 4 of H.R. 10650.

The test of "directly related"

The language of section 4 of H.R. 10650 makes clear that no item of entertainment expense is to be allowed for tax purposes unless it is "directly related to the active conduct of the taxpayer's trade or business."

The Ways and Means Committee report invokes the use of objective tests in determining whether or not a particular activity is to be considered "entertainment, amusement or recreation." At the next, and more, crucial step, however—the ascertainment of whether or not a particular activity falling within this broad category is "directly related" to the active conduct of a trade or business—it establishes a standard that seems at once to mean everything and nothing. The essence of the new rule is that "the taxpayer must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law." The fundamental difficulty with this criterion is lack of clarity. What does it mean? How will it be administered? For example, will it result in the adoption of certain rules-of-thumb such as flat percentage reductions in expenses previously deducted or considered deductible? Will taxpayers now deducting only those expenses which are "ordinary and necessary" to the conduct of their business also be penalized in much the same way as those who have been operating with less justification?

The point is that any expenditure of that type—as we have suggested earlier—is a highly individual transaction and the propriety of its deduction for tax purposes can only be determined in the light of the individual circumstances. In brief, this attempt to substitute an almost unworkable rule for more vigorous administration is not apt to cure every abuse but it almost certainly will create some injustices by improper disallowance. We shall have more to say on this matter in the course of our remarks on good-will expenditures.

Expenditures for good will

It would seem likely that—with minor exceptions—travel or entertainment expenses for the creation of good will will be denied deductibility for tax purposes. This denial has special importance to the capital goods manufacturing companies represented by the institute, an importance which derives from the character of their products.

For the most part, capital goods companies manufacture and sell a limited number of highly engineered, "big ticket," machinery items, the sale of any one of which may be consummated only over an extended period of time and—because of the capital investment involved—only after persuading a considerable number of the customer's officers and employees, all of whose voices must be heard before the ultimate purchase decision is made.

By way of example, let us suppose that the item is a machinery installation amounting to $5 million. Its sale has been accomplished by the efforts of a sales engineering "team" over a period of 2 or 3 years. Its installation and operational "shakedown" have consumed an additional period of 6 or 8 months. Moreover, after the transaction is completed, the manufacturer—as a prudent businessman—is determined to insure that the machine's future operations will be satisfactory to the customer and thus predispose him to purchase replacements or additional machines of the same type from the original source. Necessarily, a considerable amount of the business travel and entertainment expenses connected with the total sales and service effort here involved must be classified as good will expenditures. If the taxpayer is required to show as to each expenditure of this type for which deduction is claimed that he has "more than a general expectation of deriving some income at some indefinite future time," it seems likely to us that much of the total may be disallowed. This test is a wholly unrealistic criterion.

In summary, we suggest that, in many situations, capital goods manufacturers will be unable to show a "greater degree of proximate relation between the expenditure and his trade or business than is required under present law." We repeat that the implied exclusion for deductibility of most good-will type expenditures deserves reexamination and authorization for greater flexibility in the type of situation described.

Revision of the "business meals" exception.—Much of the difficulty of good-will expenditures might be overcome by changing one of the provisions of the "business meals" exception appearing in paragraph (d)(1) of section 4. Subject to certain other qualifications the expenses of business meals are still to be deductible if furnished in appropriate surroundings—"under circumstances which are of a type generally considered to be conductive to a business discussion." One can imagine a variety of circumstances involving business meals and one can also predict a wide variety of vehemently differing opinions as to what constitutes a situation conducive to business discussion. We think some improper disallowances of good-will expenditures may be avoided and an endless source of agent-taxpayer friction removed if paragraph (d)(1) were changed to read, "expenses for food and beverages furnished under circumstances which (taking into account all relevant factors) make a proper contribution to the conduct of the taxpayer's trade or business."

Club dues and fees

Although the Ways and Means Committee originally considered and then rejected a provision which would have arbitrarily disallowed 50 percent of all entertainment-type business expenses, it has, in effect, reinstituted this rule in those provisions relating to the allowance of expenses for entertainment facilities. That is to say, "No deduction otherwise allowable under this chapter shall be allowed for any item—

"(B) Facility: With respect to a facility * * * unless the taxpayer establishes that the facility was used *primarily* for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business * * *." [Emphasis added.]

This "primary use" test of the bill is supplemented by the Ways and Means Committee's explanation which declares that "if less than half of such entertainment expense would be deductible under present law, no deduction should be allowed."

This seems to us a wholly arbitrary line of demarcation and one which may stand as an invitation to misrepresentation if a businessman in fact uses the facilities of a private club both for business and social purposes. It seems to us reasonable that the portion of total club fees and dues otherwise allowable for business purposes—and as substantiated by acceptable evidence—should be treated as a deduction regardless of whether or not that portion is more or less than half the total. We urge that the bill and the accompanying report be modified accordingly.

The burden of administration

We expect that adoption of section 274 with the new tests of expense deductibility which it establishes and with the abolition of the so-called *Cohan* rule will bring about a staggering burden of administration both to the Revenue Service and the taxpayer. Consider a few examples that come readily to mind. How does one divide "objectively" a total entertainment bill into deductible and nondeductible portions by determining that part "directly related to the active conduct of the taxpayer's trade or business" and that part which is not? Does the host maintain a box score? Must the businessman now maintain a log of all use of private club facilities in order to determine whether or not such a facility is "primarily" used for activities directly related to the conduct of his trade or business? Speaking particularly of the abolition of the *Cohan* rule, at what point in the descending inmportance of expense items claimed will the de minimis standards—to which the Ways and Means Committee's technical explanation refers—be established?[6] Or may the administration of these provisions require the production of receipts for all cab rides, business meal expenditures, telephone calls, gratuities, etc.?

Traveling expenses of wives

It is difficult to say whether or not the traveling expenses of wives would be deductible under the provisions of section 274 but it seems clear that its general thrust is in the direction of disallowance, and we suspect that administration of its provisions would tend in that direction. We offer no defense for the undoubted abuses that have occurred in this area. Nevertheless, it is a fact that there are many business situations—for example, business meetings and conventions—where for business reasons it is most desirable for the employee's wife to accompany him. Would her expenses fall within the purview of the new rule which says that there must be "a clear showing of a direct relationship to the active conduct of the trade or business?" We are inclined to doubt it.

The importance of a wife's travel is even more readily apparent when the trip is of an extended nature requiring a long absence from home or to a foreign country where the social customs or traditions of that country absolutely require the presence of the wife.

Secretary Dillon's testimony of April 2, 1962

As previously recognized in this statement, Secretary Dillon in his presentation to the committee earlier this week indicated in general that section 4 of the bill did not go far enough. He argued that the cost of business entertainment, including club dues and the maintenance of extertainment facilities, should be disallowed in full as a tax deduction, subject to nine exceptions listed in the bill. He objects to the pertinent provision in H.R. 10650 on the grounds that it moves in the right direction but draws only a vaguely defined line which will cause considerable controversy and litigation. In essence, the Secretary is saying that business entertainment cases are difficult to handle, that in certain instances there are abuses, and that it is hard to draw a line between the legitimate and the illegitimate portions of the expenditure. He concludes that the only way to deal with the problem is the meat-ax approach of disallowing the entertainment expenditure altogether.

We are constrained to observe that this is neither good government nor good law. The Revenue Service confronts hundreds of situations outside the entertainment expense field where it must draw fine lines; indeed, that is its business. If new law is needed in this field, this committee should certainly insist that the Internal Revenue Service should not be in the position of abdicating its responsibility. By abolishing entertainment expense deductibility 100 percent, the Congress would create many inequities in the process of attempting to deal with the inequity attributed to abuses of expense accounts. Anyone will recognize that in many instances the entertainment expense is fully related to a legitimate business purpose and in others partially related.

We referred previously to the Secretary's comment on the need for an allocation formula with respect to travel expenses; we do not feel that a legislative formula is necessary, at least until it has clearly been shown that present statutory authority when properly administered is inadequate.

[6] With respect to de minimis standards, if the Congress decides to adopt more definitive legislation respecting business entertainment and travel expenses, then it is obliged, in our judgment, to direct the establishment of de minimis exclusions rather than merely to hint at their excludibility.

Conclusion

We feel that the Senate Finance Committee should explore further the question as to whether present law, vigorously administered, is not adequate to prevent abuses in the area of business entertainment and travel expenses. If upon such reexamination the committee concludes that new law is necessary, we feel that it is clear that the proposed provisions contained in H.R. 10650 go beyond the objective of eliminating abuses and will result, at least in some cases, in inappropriate disallowances of legitimate expenses. Further, there are certain technical points both of administrative burden and statutory standard which we have detailed and commend to further study by the committee. We call attention particularly to the following standards discussed above: (1) allowance of an expense only where it is "directly related to the active conduct of the taxpayer's trade or business"; (2) the showing of "more than a general expectation of deriving some income at some indefinite future time * * *"; (3) the furnishing of business meals under "circumstances which * * * are of a type generally considered to be conducive to a business discussion"; (4) the 50-percent-use rule for club dues and fees; and, (5) the express overruling of the Cohan rule.

Finally, we cannot fail to comment on a presumption which appears to underlie these proposals and with which we cannot agree at all. It appears that the administration has advanced these recommendations on the presumption that business generally exercises no effective control over its employee expense allowances. This, in our judgment, is totally in error.

TAXATION OF FOREIGN EARNINGS (SECS. 6, 11, 13, AND 20)

The Machinery and Allied Products Institute and its affiliate, the Council for Technological Advancement, have a deep interest in the subject of foreign investment as one important sector of foreign trade to which the capital goods industries are fully oriented. Indeed, machinery products represent the largest single class of export items shipped from the United States. Moreover, capital goods are heavily involved in foreign investment and licensing. This naturally has led the institute to perform considerable research in the foreign trade field, with particular attention being given to the economics, the commercial aspects, and the related tax policy questions of foreign investment.

An important institute contribution in this area was the pamphlet "Private Investment Abroad" (March 1961). This study—based on the operating experiences of capital goods companies—was given wide distribution in an attempt to correct apparent misunderstandings among Government and the general public on the various aspects of private investment abroad. This has been followed by continued research and representations before the Ways and Means Committee in connection with the current legislation.

Our most recent statement prior to this appearance was a rebuttal of the Treasury memorandum filed with the Ways and Means Committee after the conclusion of hearings on this bill, which memorandum was designed to refute industry testimony on this subject.

The MAPI rebuttal is offered as an appendix to our principal statement, and we request that it be included as a part of the formal record. For the convenience of the committee we summarize below the points made by the institute in this document with some amplification and updating for the convenience of the committee.

Summary of MAPI rebuttal of Treasury views on taxation of foreign subsidiary earnings

(1) The flow of capital to the developed areas would be significantly retarded if deferral on subsidiary earnings in such areas were removed, and such interruption and retardation of the flow of capital is not in the public interest.

(2) The effect of such oversea investments on the balance of payments is favorable; first, because they generate remittances in excess of capital outflows into such investments, and, secondly, because they have a strongly favorable effect on U.S. exports of goods resulting, directly and indirectly, from these investments.

(3) The favorable balance-of-payments effect of U.S. direct investments in subsidiaries located in developed countries is, in our opinion, felt much sooner than Treasury studies have suggested. Inasmuch as heavy U.S. international commitments—military alliances and foreign economic assistance—may extend indefinitely into the future, perhaps for decades, it would be foolhardy to give up future income for the sake of short-term considerations. And, obviously if invest-

ment today will benefit our payments position over the reasonably short-term future, failure to invest at this time will worsen it in subsequent years.

(4) Since U.S. direct investments abroad are normally undertaken only when foreign markets cannot be penetrated from the United States, these investments are not undertaken at the expense of domestic investments nor does the production from these investments normally replace production from domestic investments as Treasury has indicated. Indeed, these investments help maintain the overall strength of American business for several reasons, including the generation of additional earnings for American companies and the promotion of exports that would not otherwise occur.

(5) Although U.S. direct investment abroad is normally undertaken only when foreign markets cannot be served from this country, it does not follow that tax considerations are not a significant factor in inducing U.S. business to invest abroad. If a U.S. firm is faced with a prospective tax liability greater than that facing its competitors in the country of the prospective investment, it may feel compelled to forego the investment or its financial position within the competitive area will be seriously, perhaps fatally, weakened.

(6) By the same token, the Treasury's concept of tax neutrality, which calls for equalizing tax liability as between domestic and foreign subsidiaries, is inappropriate. The more appropriate concept of tax neutrality is one which would equalize tax liability as between U.S. subsidiaries abroad and the companies with which they must compete in the country or the trading area where they are located.

(7) To remove deferral on earnings in low-tax countries will not only put U.S. companies at a serious disadvantage with their European competitors, but will, in many instances, lead to the abolition of subsidiary operations in low-tax countries, with the result that greater foreign profits will be generated in high-tax European countries. The result is a loss of potential revenue to the U.S. Treasury which can never be recovered.

(8) Removal of deferral on earnings will also serve to retard the flow of capital from U.S. subsidiaries abroad to the underdeveloped areas, or, if that flow is to be maintained, it can be done only at the expense of an increased outflow of capital from the United States and a consequent worsening in this country's balance of payments.

(9) It seems altogether incongruous to upset longstanding American investment positions abroad and discourage further investment there at the very time the administration is calling for greatly increased foreign trade, including its liberal trade program being presented to Congress. Indeed, the recommendation with reference to taxation of foreign earnings and the discouragement of foreign investment smack of isolationism.

(10) International competition demands that American industry have sufficient flexibility in its international position to respond appropriately to the rapidly changing challenges of world competition. Removal of tax deferral will greatly diminish the present flexibility which permits export, manufacture abroad, investment in underdeveloped areas, etc., depending upon the situation. Moreover, the artificiality of distinctions between developed and underdeveloped areas, a cardinal point in the Treasury proposal, does not accord with the facts of economic life in international trade and is altogether inconsistent with that necessary flexibility in management to which we have just referred.

(11) From the standpoint of national policy, private investment abroad is not simply a valuable commercial asset. It is also a vital part of our total foreign-aid program providing, as it does, an opportunity for private initiative to develop self-supporting economies in so-called lesser developed areas and, at the same time, affording a most important point of people-to-people contact in all areas of the world. Its importance grows with our continuing reexamination of our foreign-aid burden.

(12) The burden of proof is on the Treasury since it seeks to overturn tax provisions which have been a part of our code since 1913. We think the Treasury memorandum fails to sustain the burden either as a matter of logic or sound economics and tax policy.

The constitutional issue

Before updating our rebuttal in the light of the April 2 Treasury statement, we should like to raise an overall legal question. We do not pose as constitutional lawyers but we should call the committee's attention to a memorandum on possible constitutional issues involved in this question prepared for the House Ways and Means Committee by the distinguished Chief of Staff of the Joint

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Committee on Internal Revenue Taxation. It appears at page 311, volume 1, of the published hearings before the Ways and Means Committee last year.

In his memorandum, Mr. Stam considers the question of constitutional power to tax a shareholder on the undistributed income of a corporation, and the tenor of his memorandum would indicate serious doubt as to the propriety of the action contemplated by certain of the foreign income tax provisions of H.R. 10650.

We acknowledge, of course, that the General Counsel of the Treasury Department responded to this memorandum in a lengthy brief, explaining his reasons for believing that such action is constitutionally proper. With due respect to Mr. Knight, we feel that the Committee on Finance is entitled to a detached view from constitutional authorities not associated with the basic policy position adopted by the executive department. We respectfully recommend, therefore, that the Committee on Finance request outside expert counsel to render a legal opinion before committee action is taken.

The position of Treasury as stated on April 2

We have referred above to the rebuttal of the institute to the Treasury memorandum furnished the Ways and Means Committee at the conclusion of its hearings. That exchange between Treasury and the institute deals with almost all, if not all, of the fundamental issues and differences of opinion and interpretation which underlie the foreign earnings controversy. It should, however, be amplified to some extent by relating the views then expressed to the Treasury testimony of April 2.

Mr. Dillon's testimony rests primarily on exhibit III, which he briefs and interprets. Since the Treasury Department's testimony, including exhibit III, has been available to us only since Monday, it is impossible to undertake a full analysis of the document. However, an initial, and we think useful, appraisal is feasible in view of our longstanding acquaintance with Treasury views in this area.

In general it is fair to say that our preliminary examination of the content and the underlying reasoning of exhibit III suggests that the inadequacies may be so great as to question whether the results deserve serious consideration at all.

First, may we comment on the statement on page 8 of exhibit III? It reads as follows: "Because opinions have been so sharply divided over this issue the Treasury Department recently undertook extensive restudy of the data in full consultation with interested business groups. We believe that the new investigation yields good measures for the major direct effects stemming from the outflow of direct investment funds, and serves to put the central issues involved in the tax deferral question in proper perspective." I am sure that some consultation took place, but the committee should not draw the conclusion that industry is in sympathy with the views or interpretations contained in this exhibit. As our discussion below will develop, we, of course, dispute directly the conclusion that the central issues are placed in proper perspective by the document under discussion.

Now, let us turn to certain of the central points contained in exhibit III and our comments thereon.

Tax neutrality.—The foundation of exhibit III, indeed underlying the whole philosophy of the Treasury approach to foreign earnings, is neutrality as a principle of taxation, but not merely neutrality, neutrality as the Treasury sees it; namely neutrality between U.S. domestic corporations and U.S. corporations operating abroad. This concept of neutrality, as we have indicated above, we reject as being neither a sound principle nor a practical one. No better statement of our view on this subject is available than that which was made by the distinguished Congressman, Hale Boggs, who on May 23, 1961, in addressing a meeting of the institute, supported continuance of the deferral on the theory of neutrality between corporations—U.S. and foreign—operating abroad.

Presumed displacement of domestic investment and domestic jobs.—Throughout the document there is the assumption that dollars discouraged from investment abroad will be invested in the United States. In other words, it is assumed that there is some investment opportunity in the United States for those dollars which would otherwise be spent abroad and that businessmen would necessarily commit themselves accordingly. This is a naive assumption; at best an academic one. Most of the business investment which takes place outside the United States today is what might be called forced investment, forced by the facts of interna-

tional competitive life, forced by disparities in competitive wage rates, and by other factors. In all my experience I have never found a capital-goods executive who would, as a matter of choice, rather do business outside the United States than at home. In this respect, exhibit III reflects some lack of understanding of the hard facts of international commerce.

Fallacious assumptions underlying the Treasury balance-of-payments argument.—The balance-of-payments difficulties which confront the United States are not to be taken lightly. But let's be completely realistic about the causes for our balance-of-payments problem and its essential characteristics. Here again we meet the Treasury head on in a conflict of opinion on a fundamental point.

The administration takes the position that we must view the balance-of-payments problem as a short-run difficulty. We believe it is a long-run problem and we are not prepared to concede the validity of changes in policy which may meet a short-run emergency in view of the Treasury, but will complicate the long-run position of the United States not only as to balance of payments but as to its position in international trade generally.

The conflict, however, runs much deeper, because Treasury exhibit III treats as irrelevant the current contribution of foreign dividends to the balance of payments and to the health of the U.S. domestic economy where such income is produced from investment which took place some years ago. Treasury insists that such benefits, such dividends from earlier foreign investment, must be excluded from the analysis of balance-of-payments difficulties. We feel obliged to ask what our present balance-of-payments posture would be if we were not currently benefiting, at least to some extent, from foreign investments made some years ago. This is indeed shortsighted thinking. Exhibit III seems to us to insist that the balance-of-payments problem should be discussed within a set of facts and a set of assumptions selected and organized to satisfy certain preconceptions.

The split between developed and underdeveloped countries.—This is a doctrinaire exercise of the facts of international trade. Let me give you a few examples. In making a comparison between the return from investment in developed versus underdeveloped countries with reference to related exports generated from the United States, exhibit III embraces the underdeveloped country opportunity on the grounds that it will show a fantastically larger return in the short run in terms of exports generated from the United States. Ergo, the Treasury says, it is perfectly sound to encourage investment in underdeveloped countries but not to do so in reference to developed countries. But the analyst does not give due weight to the question as to the willingness of the investor to put his money in underdeveloped countries with all of the attendant risks and the extended payout period as contrasted with the opportunities in developed countries. This erroneous approach is compounded by the Secretary's recommendation against the deferral privilege being extended where earnings are transferred from a foreign base company in a developed country to an underdeveloped country. This, of course, would inhibit or restrict an important source of funds for the underdeveloped countries.

Other technical defects in exhibit III.—1. On the basis of 1959–60 figures made available by the U.S. Commerce Department, the Treasury estimates that a new dollar from the United States invested in a European subsidiary or a dollar of European earnings reinvested in U.S. subsidiaries in Europe generates 10 cents of capital-goods exports from this country. However, the Treasury makes a major mistake, in our opinion, by including a $375-million transaction of a single company which purchased the outstanding stock of its British subsidiary—by far the largest of its kind ever undertaken. This transaction, as we understand it, generated no capital-goods exports; therefore, the Treasury, by including this transaction, understates the initial impact of new manufacturing investment on U.S. capital-goods exports by almost 40 percent. As we point out in our response to the Treasury's rebuttal to industry testimony of last summer, which response we are submitting today for the committee's consideration, this is a nonrecurring transaction and, in our opinion, should be excluded from the investment figures.

2. In order to determine the impact of U.S. direct investments abroad on exports of U.S. raw materials, intermediate products, and finished goods sold to or through such investments, the Treasury has divided the value of such exports to U.S. subsidiaries abroad in 1959–60 by the total book value of U.S. investments in those foreign facilities. They then concluded that a dollar of new investment will generate this volume of exports over a period of years. This procedure in our mind reflects a lack of understanding of the realities of international business life.

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A more correct procedure in our opinion would have been to attribute a greater export impact on newer investments and a diminishing impact as time progresses. Thus it is only natural to expect that initial investments would create a substantial demand over a certain period of years for components and for other supplies from U.S. manufacturers with which the subsidiary's parent has had contacts of long standing. However, as the years go by the subsidiary companies may be expected to manufacture more of their own components and to get more of their supplies from local sources as local contacts are developed. Therefore, a much greater portion of the exports should be attributed to newer investments and a smaller portion to more mature investments. If this were done the pattern of increasing investments which has been typical of the past decade would be reflected in a much greater impact on U.S. exports than is indicated by the Treasury study. Thus, in our opinion, the Treasury analysis greatly distorts the true picture. (We should note that while the export impact of U.S. investments abroad will diminish over time and that eventually the major payback will be in the form of dividends, the investment would have paid for itself by this time and dividends would be a pure plus factor. The question we are concerned with here is the length of time for investment abroad to generate a payback in terms of a return flow of dollars to the United States.)

3. As suggested above, in connection with the underdeveloped countries, the Treasury indicates that a dollar from the United States invested in underdeveloped countries, or a dollar of underdeveloped country earnings reinvested in the underdeveloped countries, would generate far more in the way of exports from the United States as compared with the export impact of such investment in industrial countries. However, the Treasury excludes from its consideration, if we understand its analysis correctly, the impact of capital flowing to the underdeveloped countries from earnings of U.S. subsidiaries in the developed areas. It is our understanding that a very substantial part of the earnings generated by U.S. subsidiaries in Europe is reinvested in subsidiaries in the underdeveloped regions. When this fact is taken into account it can be realized that a substantial part of the export impact stems from the reinvestment of these particular earnings. Hence, it follows that the total impact of U.S. investment in Europe on U.S. exports is understated on this account and that the net impact of investments in underdeveloped areas, as represented by U.S. capital outflow to these areas and reinvestment of underdeveloped countries, earnings, is rather overstated.

The inaccuracies here stem from the continuing effort to arbitrarily divide developed and underdeveloped countries, which we feel cannot properly be done.

4. When these factors are taken into account it will be shown that the actual U.S. employment impact of a dollar invested in this country as compared with that of a dollar invested abroad is very difficult to determine, and is probably overstated when account is taken of the fact that Treasury estimates have included the $375 million transaction to which we have referred and which, in our opinion, should have been excluded.

Furthermore, no one can say to what extent dollars invested abroad would have been invested in the United States. As we have already noted, business normally invests abroad not as an alternative to U.S. investments but only because it cannot meet foreign competition from a U.S. base. The Treasury gives no consideration whatever to this fact. Yet our information suggests that, because this is normally the case, the discouragement of investment abroad will have a negligible effect so far as investments in the United States are concerned.

5. We would also note that insufficient weight is given to some of the less measurable effects of investment abroad. Since it is normally undertaken as the only means of maintaining markets abroad, earnings are generated which would not otherwise accrue to the company and they can be used to strengthen the overall company organization, thus maintaining or even creating new employment for U.S. workers. Just as one example, continuing on-the-spot contact of U.S. companies with European research facilities, and also observance of technical developments in that area, can lead to the discovery of new European techniques and processes which can be applied to U.S.-built products where such processes and techniques might not otherwise be uncovered. The result is a net gain for the American economy—and the American worker who is employed—as these new processes or tchnologies are utilized.

6. Finally, we should note that the Treasury in exhibit III indicates that investments today would not generate a favorable balance until 1978 on the basis that there would be a steady growth of capital outflow to industrial countries

of 10 percent a year. If we understand their position correctly, this is based on the annual average growth rate of capital outflows into direct investments in Canada and Western Europe since 1953.

It seems to us that it is highly unlikely that the outflow of capital will continue to increase at the rate evidenced over the past 8 years. Let us remember that investments in Western Europe in 1953 totaled only $51 million. They accelerated substantially in 1955 as the formation of a European Common Market became a matter for serious discussion; accelerated further when the Common Market came into effect in 1957; grew still more as it became apparent that an integrated Europe was actually taking place; and accelerated once again with the announcement of possible entry into the Common Market by the United Kingdom. As a result of these developments the outflow of capital reached $607 million in 1961. It is our feeling that a substantial part of the outflow of American capital into the Common Market has already taken place as a result of these developments and that such outflows may be expected to level off in the future. Furthermore, it seems unlikely that an increase as large as 10 percent annually can be expected from a level as high as $607 million as compared with the 1953 level of $51 million. For in the former instance this would involve an annual increase of $5 million, but in the latter instance an increase of $61 million.

With respect to Canada it is true that the 1961 figure is somewhat low relative to that of the preceding 3 years. However, this seems to represent a realistic picture of the situation in that country. In fact, there has been no substantial increase in the outflow of capital into direct investments in Canada in the past 4 years, and we see no reason to suspect that there will be substantial increases in the future.

DETAILED COMMENTS ON FOREIGN EARNINGS PROVISIONS

At this juncture, we deal with a number of the specific provisions of H. R. 10650 on foreign source income which we feel are of particular concern to the capital goods and allied product industries and reflect bad tax policy and inequities. In making these comments on specific provisions of the bill, we again want to call the committee's attention to the fact that the institute is fundamentally opposed to the basic approach embodied in the foreign earnings sections.

Controlled foreign corporations (sec. 13)

Under this provision, a U.S. shareholder owning at least a 10-percent interest in a foreign corporation would be taxed directly on certain of that corporation's earnings provided the total American interest in that corporation exceeds 50 percent. A pro rata share of the following items of income would be included:

1. Income derived from the insurance of risks in the United States would be subject to direct taxation. The same treatment would be extended to income derived from the use of patents, copyrights, and exclusive formulas and processes substantially developed in the United States. Such patent income would include not only payments received by the foreign corporation for the use of such patents, etc., by others, but also situations where the foreign corporation itself uses such property. In this case, a certain portion of the taxable income of the corporation would be considered as "imputed" rent or royalty for the use of such property.

2. What is termed "foreign base company income" would be subjected to direct taxation unless it is reinvested in underdeveloped countries. Such income would include dividends, interest, rents, and sales income. However, if the good is either manufactured within the foreign country, or sold for use within that foreign country, the proceeds from its sale would not be covered. A "substantial transformation" test is used to determine whether or not such manufacturing has taken place in the foreign country.

If the total foreign base company income is less than 20 percent of the gross income of the controlled foreign corporation it may be disregarded. When it exceeds 80 percent, the entire gross income is included as foreign base company income.

3. In addition to the above provisions, foreign subsidiary earnings may be subject to direct taxation unless they are either invested in a business in an underdeveloped country, or in property which is necessary to the active conduct of the trade or business of the subsidiary itself. Only when the corporation has

been engaged in a business for the previous 5 years will that business be considered as a part of the corporation's trade or business; however, any business in which the foreign corporation was engaged on December 31, 1962, will qualify without regard to this 5-year rule. In addition, investments in an 80-percent-owned foreign subsidiary, subject to this same 5-year rule, will also qualify.

General comment

Section 13, as we see it, is designed to impede the continued use of the foreign base company which manages and directs in a unitary manner all of the business operations of the U.S. parent company—manufacturing, export sales, licensing, management, and technical assistance, etc., in a number of foreign countries We are strongly opposed to section 13 since its enactment would severely curtail the effectiveness of what we consider to be a legitimate instrument for the conduct of international operations. In this connection, it will be recalled that the organization of such foreign operations through a domestic subsidiary, with no direct U.S. taxation until transmittal of the foreign earnings to the U.S. parent company, would have been authorized through enactment of the Boggs bill (H.R. 5) introduced in the 86th Congress and passed by the House of Representatives just 2 years ago.

Section 13 would not deal directly with any so-called tax haven abuses as such. It would affect abuses only indirectly by discouraging admittedly legitimate foreign subsidiary operations within which abuses might have sometimes existed. This provision would, if adopted, result in direct taxation of substantially all foreign subsidiary trading and export income when third countries are involved. The same treatment would be provided for dividends, interest, and rents. In addition there would be direct taxation, in effect, on royalty income, actual and imputed, without respect to whether it was reinvested in underdeveloped countries.

Such direct taxation is wrong, in our view, because it penalizes the transactions involved, without adequate reason for doing so. Whether or not such tax treatment leads to the extinction of the foreign base company seems besides the point. (Although we hasten to add that the experience of our member companies indicates that their extinction, and the subsequent decline of foreign business, is indeed likely to be the result in many instances.) The basic issue is whether it is justifiable under the circumstances to impose direct taxation on and thus penalize certain items of subsidiary income.

Foreign base company operations.—The fundamental issue concerning foreign base companies, in our judgment, can be posed as a question: Is there a valid business purpose or reason for establishing a foreign base company to receive trading and export, licensing, and technical assistance income from transactions carried on with customers in third countries? If not, we would concede that receipt of such income by the base company might fall within the "abuse" concept. We feel that the information which has been developed before the Congress, in the past, regarding foreign business operations demonstrates conclusively that the use of foreign base companies does not in and of itself constitute a tax abuse. In this regard, during the hearings on H.R. 5 before the House Ways and Means Committee in the summer of 1959, witnesses from business and educational institutions documented in great detail the business reasons, and necessities for the existence of such base companies to manage foreign business operations. We shall only summarize some of these reasons.

1. *Direct management of foreign business operations from the United States is nearly impossible.*—It might be argued that there is no reason for these items of income to be received through the base subsidiary, that they can be received directly by the parent company in the United States, in return for management and services provided directly by it, without any detriment to the accomplishment of valid business objectives. This view ignores the reality of doing business abroad. U.S. business needs to be on the foreign scene with local people who know the area and who are familiar with local customs in order to exploit foreign markets successfully. In addition, it is advantageous for personnel of U.S. capital goods manufacturers to be on hand for the required servicing of goods and equipment sold.

2. *Foreign branch of U.S. company frequently is unsuitable.*—It might then seem that the way to handle this problem is for the U.S. company to establish a foreign branch or division of the U.S. parent. This answer is also unrealistic. Local incorporation or organization—resulting in a closer identification with the local populace—is normally desirable and occasionally absolutely necessary. Moreover, there are many situations where foreign law requires that there be

substantial local foreign interest or ownership in the operation—and this cannot be done through the branch or division form. The matter of limiting the liability of the U.S. parent company with respect to operations in the foreign area is also frequently decisive in the choice of the subsidiary rather than the branch or division type of operation.

3. *Establishment of separate foreign subsidiaries for each country usually infeasible.*—If it's necessary or desirable to use the corporate subsidiary form of organization in handling foreign business, it may be asked why isn't it possible to establish separate foreign subsidiaries in each country in which the customers purchasing the goods or using the patents, manufacturing know-how, and technical and management assistance are located? The actual oversea operating experience of our member companies indicates that this is usually not a feasible solution to the problem. Most U.S. companies doing business abroad do not have the financial resources to establish separate subsidiaries in each foreign country in which they do business. In addition, it should be noted that, as a purely practical matter, in most instances the amount of business being done in an individual country may not warrant the establishment of a separate company to handle that business within the foreign country concerned. It is much more desirable and practical to handle such business from a centralized foreign base company.

Technical objections

Beyond the overall objections raised in the preceding section, we wish to raise a number of specific objections concerning certain provisions of section 13.

1. *Income from patents, exclusive formulas, and processes, etc.*—The income derived from the use of such property by the controlled foreign corporation is subject to direct taxation to U.S. shareholders, under all conditions. We see no real reason why such income should be accorded different treatment from dividends, rents, interest, and trading income, which are excepted from such direct taxation provided they are reinvested in underdeveloped countries.

Further, the "imputed royalty" concept mentioned above is particularly objectionable. It seems clear that its use may render a substantial portion of the manufacturing income of most foreign subsidiaries subject to direct taxation.

2. *The underdeveloped-country designation.*—With the exception of the 21 countries which are in effect designated in the statute as "developed," other countries may be classified as "less developed" by the President. We think it will be impossible for a company to make sound, long-range investment plans on the basis of designations which may be subject to sudden and unpredictable change.

3. *Earnings and profits of controlled foreign corporations.*—The "earnings and profits" concept is one peculiar to American tax law. It may be extremely difficult to administer with respect to foreign corporations.

4. *The "reinvestment" provisions.*—It seems to us that to the extent that foreign income is not subject to direct taxation because it is derived from manufacturing, it should retain this qualification without regard to the manner in which it is used.

5. *The "new business" problem.*—Manufacturing earnings would be subject to direct taxation if they are invested in a business other than that currently carried on by the subsidiary, at least to the extent of the first 5 years of the operation of the new business (unless that new business was in existence on December 31, 1962). So long as such funds are being used in the active conduct of a trade or business, it should make no difference whether the trade or business is the same as or is different from that of the controlled foreign corporation.

6. *Loss offsets.*—There is apparently no provision for losses. Thus, there would seem to be no way to utilize the income generated from the operation of one foreign subsidiary to offset the losses resulting from the operation of a second foreign subsidiary without subjecting the earnings of the first to full U.S. taxation.

7. *Rental income.*—The term "rents" as used in connection with "foreign base company income" should be clarified to insure that rental income received by a controlled foreign corporation from leasing machinery and equipment is not included. Such rental income does not fall within the passive income concept used in the bill and, under no circumstances, should be subject to direct taxation.

The allocation-of-income rule (sec. 6)

This provision will permit the Internal Revenue Service to allocate taxable income in the case of sales or purchases by the U.S. corporation and its controlled foreign subsidiary on the basis of the proportion of the assets, com-

pensation of the officers and employees, and advertising, selling, and sales promotion expenses attributable to the United States and attributable to the foreign country or countries involved. Other factors, such as the special risks, if any, of the market in which the product is sold, may be included. Also, upon mutual agreement of the taxpayer and the Internal Revenue Service, some method other than that provided in the rule might be used for such allocation. However, in any event, the rule is not to be applied where the taxpayer can establish an arm's-length price for the goods in question. We are opposed to this provision. We think that the existing section 482 of the code grants the Internal Revenue Service all the authority it needs to police this area. The rule contained in section 6 contains, at best, only an illusion of certainty because certainty in an area such as this does not seem possible. Moreover, we feel that this provision may serve as an invitation to the Service to require justification on particular prices for every product being shipped to foreign countries. Finally, it should be noted that there apparently is no provision in this rule for the accommodation of losses.

The gross-up (sec. 11)

An American corporation, in order to claim a credit for foreign taxes, would be required to "gross up" dividends received from a foreign subsidiary by the amount of foreign taxes attributable to those dividends. The Internal Revenue Code, as it now stands, allows an American company to avail itself of a credit for foreign taxes paid by the foreign subsidiary which it, the American parent, is deemed to have paid. In the Treasury view, the U.S. corporation is allowed both a deduction and a credit for these foreign taxes because only the amount of the dividend received from the foreign subsidiary, after payment of the foreign taxes, is includible in the American parent's gross income.

We note that under the present law the total combined tax rates, both American and foreign, on dividends never fall below the full American rate. This being the case, we oppose this provision of the bill for the basic reason that we oppose the philosophy of section 13—it focuses on the total foreign earnings of the subsidiary rather than the foreign earnings actually received by the American shareholder which, we submit, is all that the American taxing system should be concerned with.

Expanded informational reporting requirements with respect to foreign corporations (sec. 20)

Section 6038 of the Internal Revenue Code, which was added 2 years ago under the provisions of Public Law 86-780, requires detailed annual information reporting on certain items by a domestic corporation with respect to transactions with foreign subsidiaries. The bill would make the following amendments to this annual information reporting requirement:

(1) U.S. individuals as well as U.S. corporations would have to supply such information;

(2) "control" would be redefined to include most of the existing constructive ownership rules in the code—covering spouses, children, parents, etc.;

(3) the information would pertain to any foreign subsidiary, regardless of tier, so long as there is control; and

(4) in addition to the specified types of information, the Treasury would be authorized to require information which is similar or related in nature to that specified.

There would also be certain changes in section 6046 of the code pertaining to information required in the organization and reorganization of foreign corporations.

We view the proposed expansion of annual informational reporting requirements with concern because we feel that the 1960 amendments have not been given a real chance to prove their practical value. Further, we are strongly opposed to the "similar or related" authority that would be granted to the Treasury, on the ground that it would permit the Treasury to engage in general fishing expeditions concerning foreign subsidiary operation without any specific criteria or standards to be applied with respect to the information to be sought.

Summary

In conclusion with respect to the proposals of taxation of foreign earnings, we feel that the principles which underlie these proposals are fallacious in terms of tax policy, international economics, and commercial trade. We recommend that the Committee on Finance and the Senate rethink the subject completely. With-

out withdrawing from our basic position, we have respectfully offered the committee certain technical comments in the event it is determined that legislation in the area should proceed.

This concludes the statement of the Machinery and Allied Products Institute and its affiliate the Council for Technological Advancement on the proposed Revenue Act of 1962 as contained in H.R. 10650 and on Secretary Dillon's testimony presented to this committee on April 3. We deeply appreciate the opportunity to offer our views to this distinguished committee.

APPENDIX

THE ADMINISTRATION'S PROPOSAL TO TAX FOREIGN SUBSIDIARY EARNINGS

A response to the Treasury rebuttal on this subject filed with the House Ways and Means Committee on June 29, 1961, by the Machinery and Allied Products Institute

INTRODUCTION

This memorandum discusses issues raised by a U.S. Treasury memorandum submitted to the House Ways and Means Committee on June 29, 1961, entitled "Statistical Data and Economic Issues Involved in Treasury's Testimony on Tax Deferral."[1] The Treasury memorandum undertakes to analyze the testimony of witnesses who appeared before the committee in opposition to the Treasury's proposal to impose direct taxation on the earnings of foreign subsidiaries of U.S. companies. The institute was one of many witnesses from business and the academic world testifying against that proposal. The Treasury memorandum is designed to counter the testimony of witnesses by demonstrating that such testimony is generally invalid, unsubstantiated, or irrelevant. It also undertakes to press once again many of the Treasury's arguments in favor of removing tax deferral.

In view of the importance of this question and the possibility that further congressional consideration may be given to the Treasury proposal during the current session of Congress, MAPI feels compelled to respond to the Treasury memorandum because of what we regard as the Treasury's failure to deal adequately with the force of industry testimony on the points involved and certain basic fallacies upon which the Treasury position rests.

Because our response is somewhat lengthy and takes up the Treasury memorandum in considerable detail, it seems useful to summarize at the outset the major points which this surrebutter discusses:

1. The flow of capital to the developed areas would be significantly retarded if deferral on subsidiary earnings in such areas were removed, and such interruption and retardation of the flow of capital is not in the public interest. This point is developed at some length below.

2. The effect of such oversea investments on the balance of payments is favorable; first, because they generate remittances in excess of capital outflows into such investments and, secondly, because they have a strongly favorable effect on U.S. exports of goods resulting, directly and indirectly, from these investments.

3. The favorable balance-of-payments effect of U.S. direct investments in subsidiaries located in developed countries is felt much sooner than the 17 years suggested by the Treasury.[2] Based on the experience of many companies manufacturing capital goods and allied products, this would be a period of not more than 3 or 4 years. Inasmuch as heavy U.S. international commitments—military alliances and foreign economic assistance—may extend indefinitely into the future, perhaps for decades, it would be foolhardy to give up future income for the sake of short-term considerations. And, obviously if investment today will benefit our payments position 3 or 4 years from now, failure to invest at this time will worsen it 3 or 4 years from now.

4. Since U.S. direct investments abroad are normally undertaken only when foreign markets cannot be penetrated from the United States, these investments are not undertaken at the expense of domestic investments nor does the production from these investments replace production from domestic investments as Treasury has contended. Indeed, these investments help maintain

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[1] See "President's 1961 Tax Recommendations," hearings before the House Committee on Ways and Means, 87th Cong., 1st sess.; June 5–9, 1961, p. 3522.

[2] See pp. 3527–3528, op. cit.

the overall strength of American business for several reasons, including the generation of additional earnings for American companies and the promotion of exports that would not otherwise occur.

5. Although U.S. direct investment abroad is normally undertaken only when foreign markets cannot be served from this country, it does not follow that tax considerations are not a significant factor in inducing U.S. business to invest abroad. If a U.S. firm is faced with a prospective tax liability greater than that facing its competitors in the country of the prospective investment, it may feel compelled to forgo the investment of its financial position within the competitive area will be seriously, perhaps fatally, weakened.

6. By the same token, the Treasury's concept of tax neutrality, which calls for equalizing tax liability as betyeen domestic and foreign subsidiaries, is inappropriate. The more appropriate concept of tax neutrality is one which would equalize tax liability as between U.S. subsidiaries abroad and the companies with which they must compete in the country or the trading area where they are located.

7. To remove deferral on earnings in low-tax countries will not only put U.S. companies at a serious disadvantage with their European competitors, but will, in many instances, lead to the abolition of subsidiary operations in low-tax countries, with the result that greater foreign profits will be generated in high-tax European countries. The result is a loss of potential revenue to the U.S. Treasury which can never be recovered.

8. Removal of deferral on earnings will also serve to retard the flow of capital from U.S. subsidiaries abroad to the underdeveloped areas, or, if that flow is to be maintained, it can be done only at the expense of an increased outflow of capital from the United States and a consequent worsening in this country's balance of payments.

9. It seems altogether incongruous to upset longstanding American investment positions abroad and discourage further investment there at the very time the administration is calling for greatly increased foreign trade, including its liberal trade program being presented to Congress. Indeed, the recommendation with reference to taxation of foreign earnings and the discouragement of foreign investment smack of isolationism.

10. International competition demands that American industry have sufficient flexibility in its international position to respond appropriately to the rapidly changing challenges of world competition. Removal of tax deferral will greatly diminish the present flexibility which permits export, manufacture abroad, investment in underdeveloped areas, etc., depending upon the situation. Moreover, the artificiality of distinctions between developed and underdeveloped areas, a cardinal point in the Treasury proposal, does not accord with the facts of economic life in international trade and is altogether inconsistent with that necessary flexibility in management to which we have just referred.

11. From the standpoint of national policy, private investment abroad is not simply a valuable commercial asset. It is also a vital part of our total foreign aid program providing, as it does, an opportunity for private initiative to develop self-supporting economies in so-called lesser developed areas, and, at the same time, affording a most important point of people-to-people contact in all areas of the world. Its importance grows with our continuing reexamination of our foreign aid burden.

12. The burden of proof is on the Treasury since it seeks to overturn tax provisions which have been a part of our code since 1918. We think the Treasury memorandum fails to sustain the burden either as a matter of logic or sound economics and tax policy.

All of these reasons dictate against removing deferral on earnings of any U.S. subsidiaries overseas [3]

While the purpose of the Treasury memorandum has been to respond to testimony generally, we will consider it in terms of our own testimony as presented before the House Ways and Means Committee during its hearings on this subject. Those Treasury comments with which we are in agreement are not discussed in this memorandum. Other points raised by the Treasury which are not crucial to the position we have taken also are not covered.

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[3] For a full exposition of the institute's views on this question, the reader is referred to our testimony delivered before the House Ways and Means Committee on June 7 of last year. Copies of that testimony are available upon request, including the principal statement, app. A, B, and C, and the earlier institute pamphlet, "Private Investment Abroad."

A. BALANCE-OF-PAYMENTS IMPACT OF INVESTMENT ABOARD

A significant portion of the Treasury memorandum deals with the balance-of-payments question. Considerable space is taken to press the correctness of the Treasury's argument that direct U.S. investment in subsidiaries in the industrial countries has unfavorable balance-of-payments effects. Accordingly, we will first direct our attention to the Treasury's comments about the balance-of-payments impact of U.S. investment overseas.

Relevance of worldwide balance-of-payments data

Worldwide balance-of-payments data are irrelevant, according to the Treasury, since its proposal to remove tax deferral on subsidiary earnings is largely confined to income derived from subsidiaries in the developed countries. However, corporations in so-called tax-haven countries which may also be classified underdeveloped would likewise be affected.

MAPI outlined the balance-of-payments impact of foreign investments on a global basis to show that the historical record demonstrates that the impact of such investments is strongly favorable as a rule. However, since major stress was placed on alleged differences in impact as between the developed and underdeveloped regions, we gave primary attention to the impact of investment in the industrial areas. This analysis of the balance-of-payments impact of investment in Western Europe and Canada led to far different conclusions from the Treasury's, as is pointed out below.

Problem of separating subsidiaries and branches

Treasury argues that witnesses lumped subsidiaries together with branches, and that the result thus obtained is not germane to the issue. It is pointed out that the removal of tax deferral would affect only subsidiary earnings since branch earnings are already taxable when earned. Hence, only the balance-of-payments impact of U.S. investments in subsidiaries abroad should be the subject for consideration.

Analysis of manufacturing sector.—Witnesses did not separate subsidiaries from branches in presenting their testimony because such information was not and is not now available in sufficient detail to facilitate an adequate analysis. Figures were presented, however, showing the balance-of-payments effect of U.S. direct investments in manufacturing facilities in Europe and Canada, and that balance was extremely favorable to the United States. Since manufacturing operations in Europe and Canada are predominantly in subsidiary form, this suggests that direct investments in subsidiaries in those two areas have a strongly favorable balance-of-payments impact.

It would be useful, in this connection, to refer to our testimony before the House Ways and Means Committee on June 7, 1961.

"One more word should be said concerning the administration's statistics on the U.S. payments position vis-a-vis Europe and Canada. Our figures include branch operations, the earnings from which would not be affected by removal of tax deferral. The administration's figures include only subsidiary operations which will be affected. Unfortunately, we have been informed by the Commerce Department that data are not available for earlier years which would enable us to carry the administration's analysis back through an earlier period.

"The point has been emphasized within the administration that statistics showing the favorable payments deriving from U.S. direct investments abroad over the past decade are based on branch as well as subsidiary operations. It has been suggested that the large favorable balance is due in major part to branch operations in oil and other foreign natural resources—operations which are not affected by the proposal.

"Picking up this suggestion, we analyzed the data for the manufacturing sector only. Only a negligible portion of manufacturing investments abroad are in branch operations. In fact, a recently issued Commerce Department publication shows that the value of U.S. direct investments in manufacturing branch operations abroad was only about 4 percent of total direct investments in 1957. In the case of Canada it was 2 percent. In the case of Europe it was only about 1.5 percent.

"*Payments balance with all other countries for manufacturing.*—What does this analysis of direct manufacturing investments abroad show? Table 3 shows that the balance has been positive in every year but one from 1950 through 1959. Income from direct manufacturing investments during this period totaled $3.0 billion. Total outflow into such investments was $2.2 billion. Thus, there

was an inflow of $1.77 for every $1 of outflow. This compares with total direct investments, including petroleum and other extractive industries as follows: Income totaled $18.2 billion. Total net capital outflow was $10.5 billion. The inflow was thus $1.73 for every $1 of outflow as compared with $1.77 in the case of manufacturing investments.

"*Payments balance with Western Europe for manufacturing.*—Let us look at Western Europe, confining our attention to manufacturing for the years 1957–59. (See table 4.) [Figures had not, at the time of our statement, been published for 1960.] Published Department of Commerce figures show a significantly larger net return of dollars than the administration's figures for these years even though the Commerce figures cover only the manufacturing sector (table 4).

"*Payments balance with Canada for manufacturing.*—In the case of Canada (table 2), the difference is very striking, since Commerce figures for the manufacturing sector show subtsantial surpluses while the Treasury figures show substantial deficits."

Desirability of making available details underlying Treasury figures.—The Treasury in no way attempts to respond to the points registered in the above quotation. Yet it would seem that the burden is on the Treasury to demonstrate that the figures for manufacturing are not representative of subsidiary operations generally, if such be the case. Such a showing would require making available some of the details underlying the aggregate figures cited by the Treasury in defense of its position. We feel strongly that the Treasury should reveal all of these data, including sources and methods used in their derivation, in order that they can be scrutinized by appropriate congressional staff personnel and other experts in the field. Otherwise it is impossible for ourselves or anyone else to make any informed judgments concerning the appropriateness of the interpretation given by Treasury to those figures. In the absence of such publication and valid interpretation we will continue to hold that the available published data strongly support the views we have set forth.

Limitation of Treasury analysis to 1957–60 period discussed

The Treasury defends its use of the limited period 1957–60 on the ground that these are the only years for which detailed information is available for foreign subsidiaries operating in the industrial countries. It goes on to say that the data on subsidiaries cannot be separated from the data on branches if periods prior to 1957 are brought into the picture.

According to our understanding, this is not quite accurate. It is true, however, that such data could be supplied by the Commerce Department only at great effort and expense. Nonetheless, in view of the importance of this question, it may well be desirable to consider whether additional resources should be used to obtain such data for an earlier period.

Representativeness of 1957–60 period.—Whether or not it would be feasible to get data for earlier years, the fact remains that the period 1957–60 is not representative. There has been a marked increase in U.S. total foreign direct investments in Europe beginning in 1955 as a result first of the prospective formation, and then the actual formation (in 1957) of the Common Market, an increase which has generated a substantial rise in income on such investments, which naturally tends to lag somewhat behind increases in the investments themselves.

In 1961, income on investment in Europe continued to rise, reaching $551 million, while net capital outflow during this period reached $664 million. Following this initial surge of investment some leveling off may be expected, even though current high levels may continue for some time. If this is borne out, and taking into account the continually rising income from these investments, it appears likely that the current gap will not only soon be closed, but in all likelihood will turn into a favorable balance.

With respect to European investments, therefore, it appears that even if Treasury's objective is sound—which we do not concede—it is in effect asking us to close the barn door after the horse is gone. It seems quite likely that we have already experienced the major impact of balance-of-payments deficits with Europe on direct private investment account. We may expect the gap to close and to turn to a surplus in the reasonably near future. And, again, with respect to the manufacturing sector, surpluses have been generated in most years, and we see no reason to suppose that such surpluses will not continue. The Treasury makes no reference whatever in its memorandum to this particular point. Its selective response ignores the point although it would seem to be vitally important.

Effect of single large transaction.—The Treasury takes issue with those who have objected to its inclusion within their 4-year series of one large transaction

undertaken in 1960, involving a capital outflow of some $376 million. It claims that to exclude the data of 1960 would be to argue that one can achieve greater accuracy by ignoring important evidence, and goes on to state that there have been other large capital movements in recent years and are likely to be more in the future.

The $376-million transaction, included by the Treasury, represented an expenditure by an American company to acquire the outstanding stock of its British subsidiary. According to data supplied by the Treasury in its memorandum, remittances from U.S. direct investment in subsidiaries in Western Europe would have exceeded capital outflow by $72 million during 1957-60 if the $376-million transaction were excluded. We continue to maintain that, if one is trying to project the impact of U.S. direct investments abroad on our balance of payments, a transaction of this size, special character, and infrequency grossly distorts the picture. Three comments are pertinent in this connection.

First, while companies may often engage in large transactions, we know of no company which has undertaken a transaction which has even approached this one in size. The dollar value of the single transaction in question was greater than the total annual capital outflow into direct private investment in Europe in every year since World War II up to and including 1955. (Data for pre-World War II years are not readily available.) It was also greater than the capital outflow into such investment in 1958. Further, it approached four-fifths of the total capital outflow to Europe in 1956, 1957, and 1959. In 1960, the year in which the transaction occurred, it exceeded 60 percent of the value of total other net capital outflow into direct investment in Europe. Thus, to imply that this is a relatively common occurrence by stating that "large companies are the principal figures in private capital investment abroad and often engage in large transactions" tends to distort the real picture. The figures themselves dramatically show that a transaction of this size could not have been equaled in the postwar period prior to 1956, and, as a matter of fact, has not been approached by any other transaction since that time.

Second, it should be noted that net capital outflow into direct investments in Europe, after increasing from $476 million in 1959 to $962 million in 1960, has dropped sharply to $664 million in 1961. Thus, 1960 was not a typical year and this is attributable entirely to this extraordinary transaction.

Finally, in attempting to judge the probable future level of capital outflows to Europe, which, after all, one must do in any effort to evaluate the balance-of-payments effect of maintaining present deferral, one must project in large part on the basis of the historical record. And it is well known that, in making such projections, it is normal to exclude extraordinary, nonrecurring transactions. The 1960 transaction was not just an extraordinary, non-recurring-type transaction; it was unique, judging from the historical record.

Analysis of investment data for 1950-60 period

The Treasury also holds that if a longer span of time were covered than the 1957-60 period the available data (which includes branch operations) would be even less favorable.

Western Europe.—In the case of Western Europe this is simply not true. In fact, the only years in which U.S. balance-of-payments deficits were incurred with Western Europe between 1946 and 1957 were 1950 and 1956; during the entire 1946-56 period there was a net surplus of $532 million.

Canada.—With respect to Canada, it is true that the aggregate figures now show an unfavorable balance of payments throughout the 1950's. However, this is accounted for in substantial part by the petroleum industries where branch operations represent more than one-fourth of total investments and whose remittances to the United States could not, in many cases, be affected by removing tax deferral on subsidiary earnings because many of these investments have not yet generated earnings, and may not for a long while to come. When attention is confined to manufacturing investments in Canada, which are largely in subsidiary form, the balance of payments has been extremely favorable.

Again let us cite from our earlier testimony:

"In the case of Canada, one must concede that a high level of investment has persisted throughout most of the postwar period and that the outflow of U.S. capital into direct private investment in Canada has typically exceeded the return flow in the form of remitted earnings. However, two points should be made in this regard. First, withdrawal of deferral in this case would have a limited impact on our balance-of-payments position inasmuch as the Canadian

profits tax is currently about the same as that in the United States (50 percent on all Canadian earnings in excess of $25,000 as compared with 52 percent in the United States).

"Furthermore, a very large portion of the capital outflow is represented by investment on the part of the petroleum industries. Of this, a substantial portion has been invested in exploration activities, the earnings from which have remained small. Until these investments are reflected in a greater flow of oil to the marketplace, earnings, and hence remittances, may be expected to remain low. In the meantime, because of low earnings, neither remitted dividends nor U.S. Treasury revenues would be greatly increased by withdrawing deferral, even if the Canadian income tax were much lower than it is.

"If we confine ourselves to manufacturing investments in Canada, income accruing to the U.S. companies from such investments has exceeded the capital outflow into such investments very substantially for every year since 1950, except for 1957. (Table 2 shows net capital outflows into direct investments, earnings from direct investments, and income accruing to the U.S. companies from such investments for the manufacturing, petroleum, and 'other' industries in Canada for 1950–59.) We believe, for all of these reasons, that the administration's analysis with regard to Canada is quite distorted, particularly if one thinks in terms of the manufacturing sector."

B. EXPORT IMPACT OF U.S. INVESTMENT ABROAD

Effect of investments abroad in markets for U.S.-manufactured goods

In a discussion of the impact on exports of U.S. direct investment abroad, the Treasury makes reference to a survey by the U.S. Commerce Department based on the replies of 155 manufacturing companies which account for 80 percent of all U.S. manufacturing abroad. These companies reported total exports of $2.2 billion in 1959 and $2.7 billion in 1960 to their subsidiaries and to unrelated enterprises, the exports to the latter being attributable to the existence of the foreign subsidiaries.

The results of this survey were apparently accepted by the Treasury. It is argued, however, that "the existence of a given flow of exports between U.S. companies and their subsidiaries do not show, for several reasons, the net effect of the existence of the foreign subsidiaries upon the trade components of the balance of payments." In other words, according to the Treasury, the export effect of U.S. investment in subsidiaries abroad has been exaggerated by witnesses who testified before the House Ways and Means Committee. The Treasury cites the following reasons in defense of this statement:

First, U.S. companies with foreign subsidiaries would doubtless export some goods to foreign countries even if there were no foreign subsidiaries, so that some exports are not entirely attributable to such subsidiaries.

Second, foreign subsidiaries may have a negative effect on U.S. exports through (1) displacing the domestic parent company's sales to foreign customers, (2) producing goods abroad to supply customers in the United States that would otherwise be supplied by domestic producers, and (3) applying American technical know-how and the intimate knowledge of American customer preferences to the manufacture and selling of already low-cost European products. This tends to place the foreign subsidiaries in a position that cannot be matched by some domestic firms.

As to the first of the Treasury's unproved and unprovable generalizations, no one has stated, to our knowledge, that all U.S. exports are attributable to U.S. investments abroad.

As to its other arguments, we feel that they are invalid and somewhat naive. U.S. business normally goes abroad only because it cannot penetrate foreign markets from this country. When it is recognized that American companies generally have the choice of selling from foreign facilities or not selling at all, then it becomes clear that production by U.S. direct investments abroad does not replace domestic production either in the market where the investment takes place, in third markets, or in the United States.

That U.S. companies go abroad as the only means to hold or penetrate foreign markets has been indicated to us time and again by our own member companies and we provided extensive documentation to that effect in our testimony before the House Ways and Means Committee. Given this basic fact, it follows that sales by U.S. subsidiaries abroad do not normally displace U.S. exports. Rather they displace sales by foreign competitors.

Similarly, with respect to the transmission of American technical know-how or knowledge to foreign subsidiaries, this is done for the most part only when that know-how cannot be effectively used to maintain foreign markets for domestic manufactures because costs are too far out of line, because of discriminatory tariffs, or for other reasons. This point—that investment abroad is basically to maintain or penetrate markets which cannot be served from the United States—cannot be emphasized too strongly because it is basic to a realization of the essentially beneficial impact which U.S. investments abroad have both for the economic strength of the country and for our balance of payments.

Concerning the question of sales to the United States by foreign subsidiaries, it is useful to make reference to the most recent census of U.S. business investments in foreign countries conducted by the U.S. Department of Commerce, which shows both imports by U.S. direct investments abroad and total sales by such investments in 1957. It is not, of course, meaningful to compare import and foreign sales figures in the aggregate because many items (bananas and coffee, for example) cannot be produced or grown in this country and must be imported. Therefore, they do not compete with domestic production. We can, however, show figures for the machinery industries. Machinery produced overseas is, of course, highly competitive with that manufactured in the United States. These figures show that imports into the United States from direct investments in machinery facilities abroad were only 2.4 percent of total sales by units representing such investments in 1957. In the case of Canada, the figure is only 2.1 percent. In the case of Europe, it is 3.2 percent.

In this connection, it should be stressed that where foreign manufacturers have a sufficient competitive edge over U.S. manufacturers which—because of high domestic cost of materials, labor, or the like—cannot be overcome, a company that does not import from oversea facilities will not thereby necessarily save the domestic market for U.S.-manufactured goods. Under such circumstances, the failure to establish facilities abroad will mean the abdication of the market to foreign-owned firms. For that reason, among others, we have tried continually to stress that our balance-of-payments problem, even should it be alleviated for a year or two, cannot be solved by efforts to discourage the flow of direct investment capital into oversea markets. We need urgently to turn our attention to a more basic solution, and to recognize that only through increasing the competitiveness of the U.S. economy can we induce greater investment at home. Thus, the attack on private investemnt abroad, represented by the current tax proposal, is not only unsound on the merits but avoids and obscures the central problem.

Ways in which foreign investment promotes U.S. exports

To emphasize the strongly favorable impact of U.S. direct investments overseas on U.S. exports, it is useful to cite that portion of our earlier testimony which deals with this question.

"In its discussion of the balance-of-payments question, the administration completely ignores what to us is one of the most important aspects of the whole question—namely, the impact of investments abroad on U.S. exports. It is our contention that such exports generated by U.S. investments overseas are often so great that they would exceed the value of the investments within 2, 3 or 4 years following upon the initial investments. This is the case for several reasons.

"In the first instance, the investment creates a permanent interest in foreign markets on the part of the investing company. Often U.S. companies treat foreign markets as marginal, turning to them only when domestic business declines. Obviously a company which sets up operations abroad will develop a permanent interest in such markets.

"Second, the establishment of a permanent operation overseas serves to facilitate contacts with foreign customers and by giving the company greater local identification helps to penetrate markets which could not otherwise be penetrated. One company, with which we are familiar, prior to 1959 was unable to penetrate the German market to any significant degree. However, as a result of establishing an operation in that country it now finds that its German customers are not only willing to purchase from the German-based company, but because of the greater local identification established by the U.S. company as a result of its German subsidiary, it now exports in substantial volume to the German market products which it is manufacturing in the United States.

"Third, as companies invest abroad and become oriented to foreign markets they normally develop extensive foreign distribution channels to handle the products which they are manufacturing overseas. These same distribution channels can then be used in aggressively marketing related U.S. products which are not manufactured abroad. This frequently serves to facilitate greater U.S. exports.

"Fourth, investments overseas create a demand for U.S.-manufactured components which are assembled in the company's foreign plants and can be shipped into third markets. By way of illustration, one capital goods company recently set up a manufacturing operation in Belgium, imported some of its components from its U.S. plant, assembled them in Belgium, and shipped the assembled product to Mexico. Had the company attempted to manufacture the entire product in the United States, the cost would have been too high for them to compete effectively with foreign competitors for the Mexican market. By establishing an operation in Belgium, it can sell U.S.-manufactured components in the Mexican market indirectly through its Belgium subsidiary. In short, investment abroad has saved for the company a share of the world market which would otherwise have been wholly lost, and of the total labor required to serve that market it has preserved a substantial portion for the United States by virtue of its foreign investment.

"Finally, initial demand for U.S. equipment is frequently created with the investment itself so that a significant portion of U.S. direct investments abroad is immediately offset by exports of capital goods. The balance-of-payments accounts show the full value of the investment as an outflow of dollars. But this is immediately offset in part by exports of U.S. equipment which show up in another part of the accounts under 'exports of goods and services.'

"By thus stimulating exports in the various ways outlined above, U.S. direct investments abroad not only improve our balance-of-payments position but also serve to promote a net increase in employment. This point cannot be emphasized too strongly.

"It should be stressed that the above does not represent an attempt to rationalize our position by speculating about reasons which might support that position. They are based rather on the actual experiences of capital goods manufacturers. Case after case has come to our attention of companies whose exports generated by investments abroad have exceeded the value of the initial investments within 2 or 3 years of such investments. This is important because the administration has placed such stress on the short-run problem. Surely the problem is not so short-run in nature that we need to improve our balance-of-payments this year to the detriment of that balance within only 3 or 4 years from now. We cannot believe our gold stocks are insufficient to carry us through that short period."

These facts of life in international trade must be understood by the Congress. Moreover, the Treasury must abandon its largely academic approach to the problem.

C. OTHER TREASURY ARGUMENTS FOR REMOVING DEFERRAL

Definition of tax neutrality

Having discussed the various balance-of-payments effects of U.S. investment abroad, the Treasury then turns its attention to the argument that investment in the developed countries should not be induced by "artificial" means. That is, it should not be tax-induced. It states the case as follows: "When * * * variations in tax treatment create an artificial difference in profitability as between two countries that is not justified by an explicit objective of national policy, capital may be badly allocated. It will go where it can earn the highest rate of return, after taking taxes into account, but this may not be its best location from a broad economic point of view." On the other hand, if a decision to invest abroad is not motivated by the existence of tax deferral, then, according to Treasury, removing deferral obviously cannot have any effect on the flow of capital and there should be no objection to removing deferral either on balance-of-payments or loss-of-revenue grounds.

In opposing "tax-induced" investment, the Treasury is again introducing its concept of "tax neutrality" with which we have strenuously disagreed in the past and with which we still disagree. "Tax neutrality" as we understand the term describes a situation where tax effects will have no influence one way or another on business planning—in this case on a company's decision to invest or not to invest in developed countries.

On the assumption that this is what the Treasury desires to accomplish, we contend that its definition of "tax neutrality" is an inappropriate one and we so stated in our earlier testimony before the House Ways and Means Committee. According to the Treasury's definition, neutrality is best achieved when total tax liability, U.S. and foreign combined, is the same for earnings by a U.S. investment abroad as for earnings of a competing company in the United States. We submit that this is an academic and unrealistic view of the matter. The Treasury position completely overlooks the economic facts of international existence.

We feel that taxes are more truly neutral when total tax liability is the same for earnings by a U.S. investment in a particular country as for earnings of a competitor company indigenous to that country.

It seems logical to suppose that for a businessman operating in the same investment climate, under the same Government regulations, within the same market area, etc., as his competitors, tax considerations can often be the deciding factor in the success of the business. On the other hand, where investments in two different economies are in question, each economy with its own investment climate, its own Government regulations, its own wage patterns, its own transportation problems, its own raw material sources, the tax factor would logically be much less important relative to these other considerations. Our own member companies' experiences seem to bear this out. Hence, it follows that discriminatory tax treatment with respect to earnings generated within the same country will often deter investment by the company discriminated against. A differential tax rate applied to earnings generated in one country as opposed to earnings generated in another, on the other hand, will normally have little effect relative to other, purely business considerations where two entirely different economies are involved.

Equally erroneous is the implication in the administration's argument that, to the extent that deferral affects investment decisions, it induces companies to invest abroad where they would otherwise invest in this country. It is our contention, as we have already noted, that normally business has no such alternative. In most cases its alternatives are either to invest abroad or not to invest at all simply because it cannot hold or penetrate markets abroad from the United States in the face of import restrictions, regional markets, etc. It does not follow, however, that taxes do not affect a firm's foreign investment decisions or its competitive position abroad once the investment has been made. Removing deferral would put U.S. firms at a distinct competitive disadvantage where host country taxes are lower than U.S. taxes, and the result would in many cases be a decision not to invest in that country or a hobbling of the financial strength of the U.S. investment abroad. It follows that the administration will not normally achieve true tax neutrality by removing deferral. Removal will indeed have the opposite result. It will serve as a negative inducement, discouraging investment abroad or limiting the strength of our foreign investment enterprises. And neither the United States nor American industry can afford this from the standpoint of international competition.

Validity of Treasury table

The Treasury memorandum attempts to defend a now famous table, which was produced in its original testimony, and which has come under considerable criticism.

The table purports to show that it would take 17 years under current tax deferral before accumulated remittances to the United States from the typical new investment in an oversea subsidiary would equal remittances that would have accrued if the deferral privilege had not existed. The administration admits that if earnings are plowed back instead of being remitted to this country, this will generate further earnings and eventually remittances to the United States will be greater than they would be without such reinvestment. However, the administration claims that it would take 17 years before accumulated remittances as a result of such investment under the present system of deferral would equal dividends remitted to the United States without such deferral. The argument was made that this was too long a period to await the benefits of such an investment.

Criticism of the Treasury's table was based on its assumptions concerning when and to what extent companies with subsidiaries abroad remit earnings under present tax laws and when and to what extent they would remit earnings should tax deferral on such earnings be removed. These assumptions are, in

our view, so unrealistic as to make the results completely meaningless. The Treasury has responded as follows:

"The assumptions used to construct the example were not unrealistic. It has been said that companies will not leave as much as one-half of their earnings abroad, but will repatriate a larger proportion. Yet several witnesses testified that their companies actually aim to repatriate one-half of their oversea income. Moreover, the total of dividends remitted by all foreign subsidiaries also works out to a figure close to 50 percent of income.

"Some witnesses objected that companies begin to remit profits at once and do not delay remittances for 5 years as the example assumed. But one witness told the committee that his company's Canadian subsidiary did not remit dividends to the United States for more than two decades, while its Swiss subsidiary has not done so for 8 years."

This response of the Treasury deals only with what companies do under current tax regulations. The central question concerns the extent to which companies will or will not change their practice under the proposed legislation. The assumption underlying the Treasury table is that companies will change their remittance practices substantially. We disagree.

The administration, in its example assumes that under current deferral the subsidiary will begin remitting half of its foreign tax earnings from the sixth year after the initial investment while it is assumed that without referral, remittances would begin immediately, for purposes of paying U.S. tax on the company's earnings.

We do not contend that it is necessarily unrealistic to assume that companies will leave as much as one-half of their earnings abroad or will delay remittances for 5 years. We do feel, however, that it is unwarranted to assume that a company's practices would be so completely dictated by tax policy to the exclusion of all other considerations that it would remit 30 percent of its earnings immediately (for tax payments, as in the Treasury example) without deferral, whereas it would remit no earnings for 5 years with deferral.

Furthermore, these assumptions represent pure conjecture on the part of the Treasury. Why not say the typical company would begin remittances in 1 year or 3 years or 10 years and would remit 60 or 70 or 85 percent of earnings? One could develop an infinite number of conclusions, depending upon how the assumptions were varied. We would suggest, furthermore, that one needs more historical material than the Treasury has produced even to indicate what companies are doing under the current law, disregarding for the moment the question of what they would do if deferral were removed.

No doubt maintaining deferral will have some effect in encouraging reinvestment and a corresponding reduction in profit remittaces. We hold, however, that the favorable impact on our balance of payments, resulting from the added earnings generated by such investment, would be felt relatively soon and that any net adverse effect on the balance of payments would be short lived.

The importance of timing

We feel that the question of timing cannot be stressed too strongly, for it obviously is a key consideration in the administration's thinking. Therefore, one more comment may be in order.

The importance given by the administration to the question of timing is evident from President Kennedy's address of December 6. He notes in that address that we still have some time left in which to solve our balance-of-payments problem: "The United States still holds some 43 percent of the free world's monetary gold stock, a proportion far larger than our share of its trade and clearly sufficient to tide us over a temporary deficit period—and I emphasize the word 'temporary' deficit period—while we mount an offensive to reverse these trends." Later in the same address, however, the President states, in proposing removal of tax deferral on earnings from capital invested in developed countries:

"I am aware that many of you will argue that the investment abroad of these funds will mean that ultimately and in the long run these moneys will be coming back.

"But how long a run? And, how long can we afford without taking every responsible step to try to bring this in balance in the short run? We can't wait till 1970 if we are losing $2 or $3 billion a year and we're now for the first time down to about $16,000 million in gold in the United States."

It is apparent from these statements that the President's advisers evision a very long period before investments generate a return of dollars sufficient to offset the original outflow. We contend on the contrary that it will be a much

shorter period than the Treasury has suggested and that, in addition, when the impact on exports is taken into account, direct investment in the developed areas will generate a return in excess of that investment in an even shorter period. Based on the experience of many capital goods companies, this would mean a period of not more than 3 or 4 years.

Finally, let us note that the administration, according to our understanding, envisions that our heavy international commitments will extend indefinitely into the future, perhaps for decades. If this be the case, we can ill afford to give up future income for the sake of short-term considerations. And obviously if investment today will benefit our position 3 or 4 years from now, failure to invest now will worsen it then.

Deferral contributes to greater export sales

According to the Treasury, "several witnesses said that foreign subsidiaries promote export sales for the United States. But only one tried to show that deferral is responsible for their contribution." If deferral encourages U.S. investment abroad where such investment would not otherwise take place and if such investments serve to promote exports, it would certainly seem to follow that deferral is responsible for promoting exports.

Effects of removing deferral on earnings of so-called tax haven subsidiaries

The Treasury, noting that some witnesses have defended the establishment of U.S. subsidiaries in low-tax countries, indicates that their position is untenable and in that connection refers to certain points brought up by witnesses in defense of that position.

Noting that these witnesses stressed good business reasons underlying their companies' establishment of such subsidiaries, the Treasury states that it does not take exception to these assertions, and that its proposal to remove deferral is not designed to discourage the legitimate operations of such companies.

Revenue and balance-of-payments effects of withdrawing deferral.—The Treasury answers the contention that withdrawing deferral on earnings of investments in low-tax countries would deprive it of revenues with the statement that the law was not designed primarily for revenue purposes. Nonetheless, the Treasury indicates in another context later in the memorandum that the revenue question is an important one. Treasury does not comment at all on a related observation that withdrawing deferral would damage rather than help our balance-of-payments position.

Because we feel that both of these points are extremely important, we repeat our relevant testimony before the House Ways and Means Committee describing the basis for our position on this point.

"It is perfectly true that many companies have established trading subsidiaries in low tax countries. These trading subsidiaries buy and resell goods manufactured by other of the U.S. parent company's subsidiaries (manufacturing subsidiaries) located in high tax countries. These trading subsidiaries, we should emphasize, are normally established for perfectly legitimate sales and service reasons, although the tax advantage may be an important inducement to locate in the country in question. Further, we certainly would not deny that the technique of establishing such trading companies has been abused on occasion but the administration is proposing to use a meat ax where a scalpel is required.

"It should also be noted that a substantial portion of the earnings generated by many of these trading companies is invested in the underdeveloped countries. It is the view of parent company management in many cases, as we stated earlier, that the low tax on such earnings helps to offset the high risk accruing to proposed new investments in underdeveloped areas, and hence can justify such investments where investments from earnings generated within the United States would have an extremely low priority for such investment.

"With respect to the earnings and remittances of these trading companies, what can we expect if deferral is withdrawn? Our own information indicates that in many instances the trading companies would be abandoned, having been established or maintained in part because of tax benefits. The result would be that greater profits would then be generated in the higher tax countries where manufacturing operations are located, that the governments of the latter countries would reap most of the gain in the form of increased tax revenues on these higher profits, and that where taxes approach or equal those in the United States, the U.S. Government would derive little or no revenue. But equally important, there would be smaller after-foreign-tax earnings available to the company to

invest in the underdeveloped regions or elsewhere. Therefore, this would also have the adverse effect of either reducing U.S. capital flow into direct investments in underdeveloped countries or, if such investments were to be carried forward, to increase the flow of capital from the United States which would damage rather than help this country's international payments position.

"Beyond this, we know that at least some funds generated in low tax countries are repatriated to the United States and tax dollars are thus recouped. Where the after-tax earnings of a company are less, however, as a result of greater tax payments to foreign governments, one may expect a smaller return flow of capital to the United States and a resultant loss of tax money to the U.S. Government. The United States in many instances would in effect be putting tax dollars in the pockets of foreign governments where they can never be recouped."

Validity of equity argument.—In stating that the proposed imposition of direct U.S. taxation on foreign subsidiary earnings is not primarily designed to raise revenue, the Treasury argues that the purpose is to "insure that U.S.-owned companies abroad [pay] a total of income taxes similar to that borne by domestic firms." There is the implication in this quotation that the establishment of equity as between firms with foreign operations and those without operations abroad requires removing deferral on foreign subsidiary earnings. This is an unjustified implication, as we pointed out previously. In our testimony before the Ways and Means Committee last June we said:

"We feel that equity in this instance is consistent with public policy considerations and that deferral should be maintained on all foreign subsidiary earnings for equity as well as public policy reasons.

"In the first place the present deferral concept has been inherent in our Federal income tax system since its adoption in 1913, and, as we have already noted, business has been strongly encouraged to take advantage of it by investing overseas since World War II, under both Democratic and Republican administrations. The purpose of course has been, also as noted, to facilitate the accomplishment of U.S. foreign economic policy. It should be stressed, furthermore, that such deferral may be availed of by all firms alike so in that sense there is no discrimination among or within industries.

"On the other hand, the reverse is true where deferral is removed. This is so in the first place because it would operate against firms which happen to have located in certain geographic regions for perfectly legitimate purposes. In the second place, to suddenly change tax laws which have been on the statute books for 48 years is in effect penalizing firms whose operations have been quite properly patterned on the basis of this as well as other legislation. And it should be added that many of these firms have been actively encouraged by the Government to invest abroad.

"Under the terms of the current proposal, the effects of removing deferral would not fall on all firms alike. They would fall on those companies which have been active abroad, including those which have participated in the promotion of economic development in the preindustrial areas. Costly corporate reorganization may be the only feasible alternative for such companies should present tax laws be changed. This would appear to be far more inequitable, as a matter of practical fact, than maintaining in effect current legislation."

By way of summary, if one wishes to consider the problem in terms of equity, there is excellent justification for not changing existing law for the reasons we have given. This is particularly true inasmuch as the present law has been relied upon in recent years as an inducement to business to go abroad.

Further discussion of tax-neutrality concept in context of "tax-haven" investments.—The Treasury memorandum attempts to counter our tax-neutrality concept, outlined above, which calls for U.S. firms to be on equal terms with competitor firms in the host country. It argues that only some 200 European companies "have taken advantage of taxhaven arrangements" as compared to 500 U.S. companies, and goes on to express the view that some European governments may take action similar to that proposed by the Treasury, presumably in order to discourage such activities. We do not think the numerical comparison is persuasive and the second point represents conjecture rather than fact. Conjecture, after all, can be used in defense of almost any position one wants to support; the fact is that, to our knowledge, no European government has taken such action.

Effects of removing tax deferral on the flow of capital to less-developed areas

The Treasury takes issue with the contention that removing deferral on earnings in the industrial countries will reduce the flow of capital from those countries to the less-developed areas.

In this connection they take issue with the point that high (after tax) rates of return in Europe are necessary to offset the high risks accruing in underdeveloped areas. The Treasury memorandum indicates that the governmental investment guarantee program is a means of reducing this risk and that for American companies also to ask for tax deferral as an inducement to take on risks in the less-developed countries is to pass part of the cost of such risk to the U.S. Treasury in time of reduced revenues.

We cannot accept the Treasury position.

First, the guarantee program does not cover all underdeveloped countries and, in fact, excludes some very important ones. Brazil is one example. In addition, this program guarantees only against political risk, and, for the most part, does not guarantee against "normal" business risk which is very high in many instances.[4]

Second, it is difficult to understand why, in the current context, the matter of Treasury revenues suddenly takes on such importance, especially since their proposal to increase revenues by removing deferral may significantly discourage the flow of capital to the underdeveloped regions. When discussing the argument that removing deferral on earnings in low-tax countries will reduce Government revenues, the Treasury asserted that this was not a matter of primary concern. Furthermore, the policy of encouraging investment in the less-developed regions even at some cost to the Treasury is implicit in the proposal to maintain deferral on earnings in those regions. The inconsistency is obvious. Having countered an earlier argument with the statement that revenue losses were not a matter of primary concern, Treasury now turns around and opposes the maintenance of deferral on just this very ground.

In brief, we think the facts show that the investment guarantee program does not serve adequately to offset the high risks accruing to investment in underdeveloped regions, and that the existence of low-tax dollars does encourage the flow of earnings from the developed countries to the underdeveloped areas.

The Treasury also argues that maintaining tax deferral on income earned in Europe for the purpose of encouraging reinvestment of such earnings in the less-developed countries represents an inferior method of encouraging companies to invest in the less-developed areas inasmuch as every company benefits whether or not it reinvests in such areas. They argue that investment incentives should be more selective, implying that their current proposal meets that criterion.

We fail to see the merit in this argument. This policy may be selective in the sense that it discriminates as between existing investments in the developed areas and those in the less-developed regions, but this selectivity does more to hinder than to help the Treasury's objective of encouraging investment in the latter. In this connection, we should point out that 60 percent of the undistributed earnings of U.S. subsidiaries abroad in 1960 accrued to Canadian and European subsidiaries. Undistributed earnings represent, of course, an appropriate measure of funds available for reinvestment. Undistributed earnings also represent the foreign corporate income which would be subject to U.S. tax when earned if deferral were withdrawn. A substantial portion of such earnings currently flows to underdeveloped countries and this flow would be greatly impeded if deferral were withdrawn.

Moreover, we think it improper and unwise policy to draw wholly artificial lines of demarcation between developed and so-called underdeveloped areas. At the same time that we have undertaken a program of assistance to underdeveloped areas, and the assistance of private capital is solicited, we must maintain our position against rising competition in world markets and, finally, we must prevent a worsening of our balance of payments. To accomplish all these things simultaneously America must not be boxed in by the artificiality of these definitions.

In order to emphasize the importance of earnings in the developed countries as a source of capital for investment in the less-developed regions, we think it useful to reproduce that portion of the institute's earlier testimony dealing with this subject:

"A substantial volume of investments in underdeveloped regions comes from earnings of U.S. enterprises in Europe and other industrially developed re-

[4] It is true that under the new AID program a $100 million authority to insure against all risks including risk of normal business loss has been legislated. However, this is to be used on a very selective basis.

gions, which enterprises currently generate a substantial portion of total foreign earnings. These earnings are frequently reinvested directly in underdeveloped areas instead of being brought back to the United States. Discrimination in tax treatment as between earnings from investments in the industrial regions and earnings from investments in the underdeveloped areas will thus serve only to reduce greatly a major source of venture capital for such underdeveloped regions where sources of capital are currently limited and where the U.S. Government is spending great sums to promote economic development.

"It should be emphasized that earnings brought back to this country will normally not be transferred to underdeveloped areas. We have been informed by some companies that top management is extremely reluctant to approve new investment of capital in many countries of South America, Asia, or Africa from earnings generated within the United States because of the relatively high risk accruing to such investments. They are considerably less reluctant to approve such investments from funds generated by oversea subsidiaries because they feel that the greater risks of such investment are offset to a significant degree by the lower tax liability on such earnings. Until these earnings are brought back to the United States, they are not, ofo course, subject to U.S. tax. Withdrawal of tax deferral would tend to dry up this major source of venture capital for underdeveloped areas. This is not to suggest that the tax factor is the sole consideration involved in management decisionmaking with respect to investment abroad. Indeed, there are many factors, including cost of production, market, sources of supply, and so forth. However, it is perfectly clear that the tax factor is important, particularly in connection with the creation of investment capital in developed countries for transfer to lesser developed areas."

Conclusion

This response to the Treasury Department's attempt at rebutting industry's testimony of last year on the proposal to tax foreign earnings directly is not submitted simply as a debater's argument. The resolution of issues raised by this proposal will powerfully affect, for good or ill, our position in world markets, our international balance of payments and the whole outlook of this country on its foreign trade and its foreign relations generally.

A careful examination of Government testimony thus far presented convinces us that the proposal is rooted in a fundamental lack of understanding of the realities of our foreign trade position. Moreover we think the Treasury misinterprets such factual data as it has introduced in support of the proposal, and embraces an altogether unsound tax policy.

Having examined herein the administration's proposal both from the viewpoint of our world market position and the larger considerations of public policy, we urge strongly that it be rejected. As a minimum, we feel that our response to the Treasury Department's defense of its original recommendations raises so many vital questions that it behooves the committee to defer action on this aspect of the President's tax program until these complicated issues can be studied more completely.

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The CHAIRMAN. The next witness is R. J. Landolt of the Controllers Institute of America, Committee on Federal Taxation.

STATEMENT OF R. J. LANDOLT, COMMITTEE ON FEDERAL TAXATION, CONTROLLERS INSTITUTE OF AMERICA; ACCOMPANIED BY EDWARD H. BENGTSON

Mr. LANDOLT. Mr. Chairman, I am R. J. Landolt of the Controllers Institute of America, Committee on Federal Taxation, and this is my associate on the committee, Mr. Edward Bengtson.

I would like permission of the Chair to incorporate in our testimony not only what I am going to read from here, including the attachment, which will not be read, but also what has been placed on your desk, and which I would like to offer apologies for.

The pressure of time has been such that we have not been able to give the kind of study and preparation to our testimony that we would have liked to have done.

The CHAIRMAN. What is it you want to insert in the record?

Mr. LANDOLT. I beg your pardon?

The CHAIRMAN. Did you say you wanted to make an insertion in this record?

Mr. LANDOLT. This which I will not read—the pamphlet.

The CHAIRMAN. Without objection.

Mr. LANDOLT. And the technical section on amendment to section 482, section 6, which is covered brieflly in my summary.

Throughout the comments I am going to make here, I am going to refer to this pamphlet, and identify it by saying what has been presented to the Ways and Means Committee, and I apologize that I cannot say with respect to a companion pamphlet which should have been presented to the Senate Finance Committee. Time did not permit of its preparation.

The CHAIRMAN. It will be inserted after your testimony.

Mr. LANDOLT. The Controllers Institute of America here represented by its committee on federal taxation is composed of over 5,000 members representing nearly every corporation of significance in the country engaged in manufacturing, trade, banking, communications, transportation, construction and indeed virtually every aspect

of the business economy of the United States. Its membership is primarily responsible for the financial, accounting, and tax administration of their companies. It is part of our duties to analyze tax laws and be responsible for compliance with them as well as to advise other members of management of their impact and consequences on our businesses.

I might interpolate, gentlemen, that is far from an easy job and apparently it is going to be made much rougher.

Our committee on federal taxation is deeply concerned with a number of sections of H.R. 10650. We have studied the proposed tax measure since it was first presented by the administration and through subsequent changes. This has not been easy. Our recommendations to the Committee on Ways and Means of the House of Representatives have heretofore been furnished to you but additional copies have been made available for this hearing. That is the pamphlet to which I referred where we have dealt rather technically with the questions to which we are addressing ourselves.

While numerous changes have been made in th tax proposals, we feel that our comments in connection therewith are still substantially valid, but certain specifics will be dealt with at this hearing.

We would like to point out that various provisions of H.R. 10650 have been strongly opposed by almost the entire business community of our country. As business is the vital factor in generating the revenues on which our economy is dependent, we hope and feel our experience and opinions in this area will be accorded some weight with this distinguished body.

My next comments will be somewhat apropos of the comments made by Senator Morton to Mr. Stewart.

Our administration is urging us to expand our exports and foreign trade—parenthetically on the proposed legislation—and at the same time providing handicaps and penalties for so doing. One might wonder if we aren't dared to expand in this field. We are supposed to, but if we do, here are the penalties and handicaps.

Many experts have testified on this phase, but apparently to no avail as of now. I am referring specifically to the fact that in spite of all the testimony before the Committee on Ways and Means, the provisions that were basically opposed by the business community were still incorporated in the legislation that was enacted, that was passed, by the House.

Our Treasury Department and Internal Revenue Service officials boast that we have in the United States the greatest self-assessing system of taxation in the world, and yet insist that the take of the Government must come off the top before it is clearly established that the Government is entitled to a take. This is primarily addressed to withholding.

In addition, it is claimed that $25 billion of income is currently unreported, which would yield about $5 billion of additional taxes. We have computed that to be roughly about 5 percent of the annual take.

We submit that this shows about 95-percent efficiency, which by most standards would be considered excellent. Would that we could show as fine a record in other aspects of our public affairs, and I might also add in our industrial affairs. This is not to condone tax eva-

sion, and I am referring to the unreported income, but to illustrate that, one might get 95-percent efficiency at a reasonable cost but to get a higher yield almost always costs more than it is worth.

In manufacturing processes, in chemistry and many, many cases, you can get a very satisfactory cost on a 95-percent yield, but as far as efficiency or perfection is concerned you cannot afford to spend more than what costs you 95 percent because the difference could not possibly be justified costwise.

Much publicity has been given to loopholes and loophole closing in connection with this bill. We submit that much of this is clearly erroneous if not downright dishonest, and I want no mistake made, I am not referring at this point to this body, to the Congress, or to the administration, but I have read many, many editorials, newspaper articles, where they make it fairly clear to the public that, in their careless reporting, loopholes represent dishonest payment of taxes by the general public, corporations, as well as individuals, in spite of the fact that they are not loopholes.

Loopholes are inadvertences in tax law, not carefully considered provisions passed by the Congress after due study and deliberation. The term implies taking advantage of an omission of error where the actual fact is the taxpayer is complying with both the intent and letter of the law. In spite of this the investment incentive credit is clearly a gimmick, and I am using again the term that has been widely publicized in the press of the country, opposed generally by business which clearly wants, and has strongly expressed the need for, more realistic depreciation allowances.

At this point, I find myself in opposition to my good friend Charles Stewart, of MAPI. But our Controllers Institute, through the expression of all of its members and its tax committee, have canvassed them to the extent possible, and with rare exceptions we just do not feel the investment credit is the answer to our needs.

At a time when our economy is not as robust as desired, what is needed is a healthy climate in which business can invest and expand in confidence without the fear that the rules are to be changed at a later date. What we need is a respite from additional tax laws which drastically revise the rules of the game under which the public's money has been invested.

I would like to take just a moment to point out the fact that the mere study of H.R. 10650 is a tremendous job in itself. All the proposed amendments, some of which have been suggested to this committee just this week, when and as the law is finally enacted, every controller in the country, either personally or through the head of his tax department, is going to have to read and understand how the thing will work, how it can be complied with, how to administer our accounting systems, and so forth, to get the information necessary on how to advise the rest of our management on decisions that are to be taken in which taxes are an important consideration.

We have got so much tax law now that there are very few people who can get a clear-cut opinion from their tax counsel. If you do thus and so, here are the results. They will tell us, "We think you are within the law, you are probably all right, but until an issue may go to court, depending on how the court decides it, we cannot tell you."

This is a bad position to be in. The body of tax law in this country is so enormous and so complex that you just never know from day to day where you stand, and yet we are supposed to run our business primarily to produce goods and services, to distribute them, to add to the welfare of the country, of its people, and to our general economy; and too much attention of top management is devoted to tax laws and their consequences, and I sometimes get the impression that we have got the tail wagging the dog.

Under the proposed legislation it would be years before we can know the tax consequences. Regulations would have to be promulgated, and in that connection I might say under the 1954 code I think there are still some regulations not yet supplied, many of them came along years later, returns examined, rulings made, et cetera, and court decisions handed down before there could be a clear body of tax law understood by business and providing a guideline for investment. This is not to say we oppose all changes. In fact, many are desirable and needed. But the change with respect to taxation of foreign income hardly falls in this category.

We will now touch on the various and more specific sections of the bill with respect to which we have comments and recommendations, generally slightly over and beyond what is contained in this pamphlet.

For the purpose of conserving time, our comments are brief, and either reiterate the salient features of the testimony, presented to the Committee on Ways and Means, which you have before you, or are supplementary thereto. It is worthy of mention that various sections of the bill apply to either personal income taxes or to taxation of specific segments of the business community, such as insurance companies or cooperatives, for which we offer no comment as they are not proper subjects for the Controllers Institute to consider.

I might mention for the information of this body that under the scope of duties of the committee on Federal taxation we are not permitted to comment on personal income taxes, a specific company, or a narrow segment of the industry.

For example, we have members of the industry that are connected with, I mean of the Controllers Institute, connections with, banks, some with the liquor industry, insurance business, textile industry, something of that sort. Most of them have trade associations through which they are much better able to express their views on proposed legislation than we feel could properly be done by the Controllers Institute.

So, normally, we hit only upon those questions that cut across pretty clearly the broad membership of the institute.

Our comments are confined to proposed legislation which cuts broadly across all segments of the businesses of our membership.

SECTION 2—CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

Our recommendation is against this proposal and in favor of more realistic depreciation allowances. We feel strongly that the proposal will not produce the results expected from it, and consider it highly unlikely that this investment incentive will last very long as a section of our tax code, if enacted. Here we are trying to foresee the future, but I can well imagine the hue and cry that is raised when it is found

out and publicized through the press that some of the industrial giants in this country are getting the benefit of $100 million a year or thereabouts in this investment credit, and we think there will be enormous pressure on the administration and the Congress to abolish this. It will then be called a loophole.

It will not be a major factor in expanding investments. This will still depend on profit prospects. You do not invest simply because you are going to get 7 or 8 percent or 3 or 4 percent back on the qualified investment.

If somebody were to give you a plant that cost $10 million, and you had to operate it and you are going to lose money on it every year, the investment credit would be no incentive whatever to take it over.

Depressed industries or companies will benefit least from it. They would still have to obtain the cash to invest, which in many cases would be difficult to do.

SECTION 3—APPEARANCE, ET CETERA, WITH RESPECT TO LEGISLATION

We recommend in lieu thereof, in lieu of this H.R. 10650, the language of H.R. 7123 of the 86th Congress. The language of this section—and I am referring again now to the current bill—is so restrictive as to possibly deny proper communication with stockholders, because the language of the bill says "any important segment of the public." Well, you might consider 15 million stockholders an important segment of the public. Companies may want to communicate a message to their stockholders. It could conceivably be disallowed, the expense attributable to such communication, under the language of this proposed bill.

It should not deny business the right to be heard on legislative matters of great import to it. Unions operate freely in this field and business should have an equal right. Reference is made here to the restrictions imposed under section (2)(b).

SECTION 4—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ET CETERA, EXPENSES

Our strong feeling is that any abuses in this area can be readily cured under present law by proper audit and enforcement. The cases of abuse are highlighted, but the major compliance with the spirit and intent of the law is overlooked. All we hear about are abuses. I do not know whether anybody has ever summarized and said it is 20 percent of the taxpayers guilty of abuses or 50 or 10 percent. In my own judgment it is a very small percentage, possibly 10. But as to the major compliance, nobody gives them credit for it and again we are getting back to the question, Do we want 100 percent efficiency in our tax laws or administration, or are we willing to settle for a reasonable figure.

All must suffer for the few, percentagewise. Who is to determine what is "reasonable" in every case? What is reasonable in the eyes of one taxpayer is one thing; in the eyes of another taxpayer it may be something else; in the eyes of the revenue agent something else; the man who reviews the examination of the agent, something else. I do not know that any of us would ever know where we stood on a lot of questions. This can and will vary all over the lot, and the judg-

ment of no one is omnipotent. There is a little objection to this word "omnipotent," and maybe "omniscient" is a better term.

All I am trying to bring out is whether it is my judgment, your judgment, or anybody else's judgment. I think we all agree none of us are infallible. There have got to be honest differences of opinion.

An honest taxpayer could and probably would have continuing trouble with the Internal Revenue Service.

SECTION 6—AMENDMENT OF SECTION 482

This section had not been included in our statements before the Committee on Ways and Means. It is not in the pamphlet. A complete statement is attached hereto, and that is the attachment marked section 6, which I will not read. I am touching the highlights in here.

In general, we feel this section as written creates more trouble and expense for the taxpayer than it could possibly be worth. It would practically require bookkeeping for all foreign subsidiaries or a basis required for U.S. taxpayers, and vastly expanded at that. Any abuses should be corrected but certainly in as practical a manner as possible. We feel strongly that the language used here creates burdens and complexities which cannot be met. The present law would seem to serve the announced purpose much better than that contained in H.R. 10650. I am talking here about all of the requirements for information which, in the case of a foreign subsidiary, and depending on the laws, tax laws, and other factors of the country, and the general practice, you will find nowhere in this world that I know of, the type of accounting and bookkeeping and information compilation for tax returns and other purposes that we have in the United States.

If we own 50 percent of a foreign subsidiary, and we would be covered by this, I do not know how we would get the information.

If we asked the company to furnish it, and this creates additional expense which, in turn, reduces their income, they would say they won't furnish it.

Maybe by law in some countries they would not be allowed to furnish it. Maybe they would permit us to send a staff of experts in from the United States to go over their books and compile all this information. Maybe they would. We doubt it.

We also doubt whether there are enough trained accounting personnel familiar with the problems of each one of these foreign subsidiaries in various industries to go abroad and get the information, and I am referring here primarily to the accounting problems, the information necessary to comply with this law which, from an operating standpoint, I am just dead sure cannot be met.

SECTION 11—DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

We feel that this section discriminates as between foreign branches and foreign subsidiaries and call your attention to the possibility of serious effect on U.S. revenues if retaliatory measures are enacted by foreign governments.

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

Our basic objections to the language of this section are spelled out more clearly in our presentation which you now have before you. Briefly we feel that it is impracticable if not impossible to comply and to administer. The details and work involved are enormous, and this is the same thing I was referring to in the previous section, section 6.

Foreign bookkeeping does not lend itself to this provision and exactly how it can be done is everything but clear. The Treasury has claimed that all they are seeking is to have equal treatment between controlled foreign corporations and U.S. corporations. However, section 13 has failed to do this in many respects:

1. No net operating loss carryovers or carrybacks are allowed.
2. No consolidated returns are permitted.
3. There are no election privileges permitted such as LIFO, completed contract basis of accounting and many others.
4. There is no lower tax rate for earnings of less than $25,000.
5. There are no depreciation or depletion elections.
6. There are no tax-free reorganization privileges.

This last one is perhaps the most important because it is true that there are many, many corporate setups which were established for valid business reasons which are now most disadvantageous under section 13; for example, a subsidiary of a controlled foreign corporation is much more disadvantageous than if it were directly owned by the U.S. parent. Therefore, it would be only fair to provide that there could be tax-free reorganizations of controlled foreign corporations. On this assumption, this provision should go in. We are against the provision, but we are pointing out that these are areas in which we are denied many privileges, and there is not the equality of treatment between a U.S. corporation and a foreign controlled corporation, which is apparently the intent of the administration in the language of the bill.

Subpart F income from patents, copyrights, secret processes, etc., is taxable even though they were acquired from a totally unrelated person in an arm's length transaction years ago, so long as they arose in the United States. Furthermore, this kind of income is taxable in the United States even if it cannot be gotten out of a foreign country because of exchange restrictions.

This section requires bookkeeping in accordance with the United States Code and thus will require a completely separate set of books and will require U.S. trained personnel and constant retraining. It further requires a tracing of assets year after year, which is not required in the United States and will again require specially trained people.

Section 16 of H.R. 10650 applies only to sales or liquidations of controlled foreign corporations, i.e., foreign corporations of which more than 50 percent of the stock is owned by U.S. persons. However, if section 16 is applicable, all of the earnings and profits accumulated after February 28, 1913, are treated as a dividend. This would include all earnings accumulated prior to 1963 and earnings after 1962 which are not currently included in a shareholder's income by section 13 of the bill. The objective stated in the committee report

is to impose the full U.S. tax when income earned abroad is repatriated. See page 76 of the official print.

We feel the retroactive provisions are unfair and undesirable as well as incompatible with the theories propounded by the Committee on Ways and Means.

SECTION 19—WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

We have heretofore given comments on the purpose as well as the language of this section. With the provisions for exemptions and exceptions, which are not fully equitable, the burden to business is greatly increased. We believe that the educational efforts to secure better compliance were not given a fair trial.

I might mention that the Controllers Institute started work 2 years or more ago with the Treasury Department. At that time Mr. Scribner was the Assistant Secretary of the Treasury. Many, many organizations voluntarily undertook to help put on an educational program to advise stockholders and interest recipients of their responsibilities in including this in their report of taxable income where proper, which was generally the case.

We heard fairly glowing reports officially released by the Treasury Department that this program was showing very good effects.

Shortly after 1961 we were told that the effects were exactly the reverse of what we had been told a short time prior, and that the educational effort had failed—we must have a withholding on it.

There is a wealth of testimony which was presented to Mr. Scribner by many, many organizations that dealt with all the technical complexities of withholding.

It is by no manner of means as simple as wage and salary withholding, by no manner of means. We had estimates that varied from 10 cents a check, the cost of withholding in issuing a dividend check, for example, to as high as $1.50.

This can vary all over the lot, depending on whether they have an electronic system, electronic computers, or whether they have checks written manually, by typewriter, longhand, or what have you. It would represent an enormous cost, we feel, to the business community of the country.

We feel that the cost would also be very considerable to the U.S. Government. I do not know that I remember the official estimate of what the number of refunds per quarter might be, but something sticks in my mind that it might run as high as 35 million refunds a quarter.

Assuming that is an abnormal figure, and it might be only 50 million for the entire year—if we are talking about the cost to issue a refund, check it, write the check, reconcile the check with the bank balance, and make sure that the refund is proper, compare it with the individual's tax return and with the withholding, et cetera, you could easily have a cost of $5 per refund.

The Treasury and Internal Revenue Service might say it would be 10 cents, I do not know. I do not think anybody really knows.

But if we had 50 million refunds it is certainly an enormous cost to the Government.

That is also matched with the enormous cost to industry of doing the withholding, and the additional revenue which is purported to come from dividends and interest withholding might not be enough to offset the expense. At most it might represent a small gain.

We think that with respect to the figures—and they were thoroughly gone into 2 years ago and on a somewhat continuing basis until early last year—there were many sharp differences of opinion as to the unreported dividends and unreported interest payments.

Bearing in mind that the $50 exclusion and 4-percent credit might have made many dividends of $50 or less of many small stockholders nontaxable anyway.

It is our recommendation that reporting of interest be put on the same basis as for dividends. Interest currently is reported at $600 a year or more; dividends, $10 per dividend. We feel that a lot of the unreported interest might be picked up if the reporting requirements on interest were put on the same basis as that for dividends.

The many millions of refunds required will greatly increase the cost of Government and the public will suffer where money withheld did not constitute tax on income. For example, under the exceptions in the exemptions, as I have studied the bill, pension funds which constitute a very significant figure in this country, would not be allowed an exemption. The tax would be withheld.

The pension funds are nontaxable, the earnings of the pension fund ergo would have to suffer as less money is available currently each year to invest to earn a return on the pension funds.

In addition, regardless of the fact that refunds ought to be made, whether quarterly, semiannually or annually, that would not make any difference.

At the time a refund is made, additional withholdings would have been made so, in effect, you would have a permanent inventory of withheld amounts which the government would have like an industrial outfit might have, a more or less permanent inventory fixed between certain levels on hand at all times to stay in business. There is no way to ever get it down to zero.

Senator BENNETT. This would be like the float in a banking transaction.

Mr. LANDOLT. In a bank, right; and it would be a very significant amount and, in effect, it represents a tax-free loan to the Government.

Senator WILLIAMS. Under this withholding, as you understand it, would there be withholding on coupon bonds in foreign countries.

Mr. LANDOLT. That, sir, I am afraid I am not personally qualified to answer. Would you know whether that is?

Mr. BENGTSON. No, sir.

Mr. LANDOLT. I am under the impression that only—I am sorry I cannot answer your question, sir. If I would check the code I might find the answer.

Keeping current with exemptions and exceptions will be a great headache for all concerned. For example, children under 18 will be exempt.

Well, they file a certificate, they are 16 today or they are 17. We have got to watch and see when they become 18. People would say they have no taxable income this year, and we have to go back again next year to find out whether they think they will have a taxable income.

When we refer to stockholders primarily as against the recipients of interest, we have enough trouble keeping in touch with our stockholders because it is a major concern to many, many corporations that they cannot get their dividends checks cashed.

They spend a lot of time trying to find out where the stockholder is now living. The check is returned or for some reason or other it is lost in the mail, and the checks are not cashed.

Proxy statements are sent out regardless of the fact that many of them normally will not send back a proxy statement, and there are plenty that are returned because of wrong addresses. People move. So this is going to be a real headache for us.

Section 20. Information with respect to certain foreign corporations.

With respect to this section we wish to reiterate the objections voiced in our letter of January 30, 1962, to Chairman Wilbur D. Mills. The cost of complying will represent still another great burden to business. We are all conscious of the necessity of reducing the enormous overhead in present-day business where prices are highly competitive and profits steadily shrinking.

I would like to interpolate something here apropos of the discussion earlier today with regard to foreign subsidiaries. There is not only a vast gap between labor prices in many foreign countries and those in the United States, but, by and large, from the studies I have seen, the overhead cost of conducting business abroad as a percent of sales in infinitely less—I should not use the word "infinitely"—is generally less and quite often much less.

I might mention an illustration, that I have known of corporations in this country where 50 percent of their total employment is engaged in productive work, I mean turning out something to sell, and the other 50 percent are unproductive.

Years ago you might have had a ratio for small machine shops, things of that sort, out of 100 people, 90 people were producing things, and 10 people represented overhead. This has steadily grown over the years.

The complexity of our laws, not the least of which are tax laws, is one of the things which adds to this overhead. If we cannot pass along in prices, which has been done to a large extent up to now, and also which has been pricing us out of competition with foreign manufacturers and out of world markets, under present conditions, we constantly add to this overhead, and I don't think if we do so we are going to improve our situation. It is steadily getting worse.

The provisions of this section along with many others in H.R. 10650 greatly increase business overhead as well as requiring more and more of management's time for concern with taxes instead of being devoted to developing more and better products at less cost.

In closing, we wish to emphasize that we strongly feel the adoption into law of the sections commented upon will seriously and adversely affect business at a time when help rather than hindrance is indicated. Thank you for your attention and consideration.

(The attachments and letter of January 30, 1962, referred to follow:)

SECTION 6—AMENDMENT OF SECTION 482

Section 6 of H.R. 10650 would, in general, amend the present provisions of section 482 of the code so as to provide that, in those instances in which the taxpayer could not establish that sales of tangible property between members of a controlled group of corporations, at least one of which was a foreign corporation, have been consummated at "arm's length" prices, the Secretary would be authorized, unless some other method of allocation was mutually agreed to by the Commissioner and the taxpayer, to allocate the taxable income of the group arising from such sales by taking into consideration, on the basis of the relationship of that portion attributable in the United States to the total, the real and tangible personal property (including leased property) of the group, the compensation of its officers and employees, and its advertising, selling and sales promotion expenses (including technical and servicing expenses) to the extent attributable to or used in the production, distribution, and sale of the property, as well as other factors including special risks of the market in which the property is sold. However, no allocation of total group profits would be made to any foreign organization whose assets, personnel, and office and other facilities which were not attributable to the United States were grossly inadequate for its activities outside the United States.

This amendment to section 482 has been proposed because of the difficulties which the Treasury has allegedly encountered in administering the provisions of section 482 as presently written, which permit the Secretary to allocate income where this is necessary to prevent evasion or clearly reflect income. The Controllers Institute is in complete sympathy with the Treasury Department in its attempt to correct any abuses attributable to improper pricing. However, we do not believe that the proposed amendment is desirable or necessary at the present time in view of the steps which the Internal Revenue Service has taken through the establishment of the International Operations Division and a more intensified audit of intercorporate relationships. These administrative improvements, together with the increased information available to the Treasury Department under the provision of section 6038 enacted into law in 1960 with respect to operations of foreign corporations controlled directly or indirectly by domestic corporations, should permit the Commissioner to correct such abuses within the framework of present law without imposing harsh administrative provisions on bona fide business operations and subjecting such businesses to unknown interpretations of broad general provisions which are just as susceptible of varying interpretations as those contained in section 482 as presently constituted and regulations issued thereunder.

Bona fide foreign business operations are very complex, involving the sale of multilines of products to multiple foreign subsidiaries for resale by such subsidiaries in diverse market areas through varying channels of distribution under varying terms and conditions of sale. They also involve the sale of components for use by foreign manufacturing subsidiaries in their own manufacturing processes—components of the same general type which are used by the domestic manufacturer in its own manufacturing operations. In the case of the domestic manufacturer, its manufacturing facilities and personnel engaged in the production and sale of products sold domestically or to foreign external cusomers are the same as those engaged in the manufaucture and distribution of products or components sold to foreign related corporations. In the case of the foreign subsidiary its sales distribution channels are utilized both for the sale of products imported from its parent corporation and products manufactured locally. The selling prices of its products, whether imported or manufactured locally, are determined by local market conditions, and patricularly with respect to products manufactured locally but using components purchased from its parent corporation, are not dependent upon the cost of such products or any component thereof.

In the foreign market, to a greater degree than domestically, sales of products are made on a time or installment basis and in many instances under arrangements where the financing factor cannot be segregated as a seaparte income producing service. The bases for determination of taxable income vary from country to country with the amount of income expressed in terms of U.S. currency fluctuating (at times completely disappearing) because of variations in exchange rates.

From the accounting standpoint, therefore, a corporation engaged in bona fide manufacturing and selling operations through a foreign corporation or corporations does not and could not maintain its records in such a manner as to determine the income realized by the group from the ultimate end sale of a particular product or component or the facilities, personnel, and selling expenses applicable to the manufacture, production, and sale of a particular product or component. The facilities, personnel, expenses, and income applicable to products and components which would be subject to the allocation formula and products and components which would not be subject to the allocation formula would be so inextricably interwoven that any attempt to determine the factors necessary for applying the formula method would be an exercise in futility.

In addition, if section 6 is enacted into law, and assuming (which is not true) that the taxable income resulting from the sale of a particular product or component and the facilities, compensation, and selling expenses applicable thereto could be determined, it could be expected that the Service would attempt to apply the three-factor formula in all instances, even in instances where, all things considered, the actual transaction, took place at a fair price and notwithstanding the fact that the three factors specifically mentioned are not the only factors which would have a bearing on whether or not the domestic corporation had been properly compensated for its efforts. Other important factors would include the relationship of supply and demand at the time of sale both here and abroad, the specific manufacturing, assembly, or selling functions performed or assumed by each party, the various levels in the distribution channel at which the sales were made, the conditions of sale, whether such sales were made on a cash, credit, or installment basis, the degree of stability of the foreign currency involved, the dangers of expropriation, the normal profit margins realized by the respective corporations with respect to the functions performed by it, the efficiencies of operations of each, the extent to which the manufacture of components domestically absorbs fixed overhead expenses which otherwise would be borne by domestic sales, the effect of competition by foreign nonrelated competitors, and the like. All pertinent factors would vary both by individual products and the market areas involved.

In summary, the proposed amendment would only substitute new generalized and inadequate language in place of the present provisions of section 482 and applicable regulations. The proposed provisions would be no more productive of determinations of fair and reasonable prices at which products should be sold to related foreign corporations than present provisions. To the extent that sham or paper arrangements have existed under present law, the Treasury Department is in a position to correct these situations under the authority it now has and by means of steps which it is now taking, fortified with information available to it at the present time as a result of the enactment in 1960 of section 6038, which information has not previously been available for audit purposes. The proposed provisions would only impose harsh administrative requirements on bona fide operations which are being conducted on completely ethical principles. It seems appropriate, therefore, that consideration of any modification of section 482 be deferred until there has been an opportunity to appraise the effectiveness of the Treasury's newly instituted intensive enforcement program.

At the most any modification at this time should not go further than to provide that, for purposes of section 482, a controlled foreign corporation will not be deemed to be a separate corporate entity unless it is engaged in substantial bona fide operations abroad consistent with the requirements of the business in which it is engaged.

CONTROLLERS INSTITUTE OF AMERICA,
New York, N.Y., January 30, 1962.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN MILLS: The Controllers Institute Committee on Federal Taxation appeared before the Committee on Ways and Means on May 17 and 19, and also on June 8, 1961, and presented written memorandums on subjects under consideration in the Committee on Ways and Means this past spring and summer. For the most part, those papers are still relevant to the committee discussion

draft (of the revenue bill of 1961 prepared for the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation) and to the July 28, 1961, Treasury Department tentative draft bill on tax haven legislation.

We have, however, prepared new statements representing our viewpoints on the revised committee print and on the July 28, 1961, Treasury draft of proposed tax haven legislation. We did not, in drafting these statements, expect your committee to act upon these tax proposals so promptly on their return to session nor with the dispatch with which they acted. In addition, inasmuch as these tax proposals are substantially different from the administration's tax proposals on which your committee held public hearings in 1961, we had high hopes that you would also have public hearings on these revised tax proposals.

We believe that adopting the bill as a package would have a severely adverse effect on business.

Respectfully submitted.

F. V. OLDS,
Chairman, Committee on Federal Taxation.

SECTION 2—THE INVESTMENT INCENTIVE CREDIT

As outlined in the President's tax message in April last year, the investment incentive credit proposal drew prompt and overwhelmingly unfavorable reaction. There was both disappointment that the credit approach was to be taken in lieu of a start on true depreciation reform at that time and dismay that adoption of this proposal was conditioned on acceptance of various other changes, most of which were viewed by business generally as being punitive in nature and entirely unacceptable. Given an election, of the administration's whole package or Congress doing nothing, most taxpayers would have selected the latter.

Considering the credit alone, earlier opposition, is diminishing

With the release of the discussion draft of a proposed bill by the Committee on Ways and Means, and continued assurances by the administration that the incentive credit would not be considered as a substitute for depreciation reform, earlier opposition to this proposal has been somewhat dissipated. Considered alone, the tax credit proposal could now undoubtedly have the support of a large segment of American business—just as would any other measure which promised some degree of relief from the present oppressively heavy tax burden. From a purely practical standpoint, however, this committee continues to have certain reservations concerning the proposed legislation.

The credit is evidence of the administration's cognizance that present depreciation policies are inadequate

The announced purpose and the reasons cited by proponents in support of adoption of the incentive credit recognize and, in effect, constitute a tacit admission of the fact that taxes are presently too high, that the economy would profit by a reduction of this burden. Yet the approach proposed to meet the problem is highly selective in its application and would be readily susceptible to attack immediately on enactment, as a subsidy to larger taxpayers or as another loophole. As proclaimed by its sponsors, it would also be subject to adjustment, modification or withdrawal "depending upon the needs of the economy," with the result that a taxpayer committing funds could seldom be entirely certain of the extent to which he would be entitled to a tax credit, if at all, by the time his project or installation was completed. Likewise, while reasoning from the implied premise that a tax reduction produced by the incentive credit would have a salutary effect on the economy, albeit on a selective basis, adoption of even this limited relief is made contingent on acceptance of other changes which would increase tax costs throughout the economy and increase administrative costs for both business and the Government.

Even though the proposal would reduce taxes, the institute opposes it, if its enactment is conditioned on the other tax proposals in the discussion draft

It would be most unrealistic to take the position that the business community would reject a tax reduction available through the medium of the investment incentive credit, particularly if this is the extent to which tax relief can be expected at this time. We believe, however, that this proposal should be rejected unless it is presented and can be considered entirely on its own merits, separate and apart from the other tax proposals presently contained in the discussion draft.

Real depreciation would be more effective

Similarly, we should like to restate our basic position, which is, that depreciation reform at this time would be far more desirable and infinitely more effective than the hitherto untried investment credit approach, probably with a smaller ultimate net loss of tax revenues to the Government but absolutely with greater certainty and substantially fewer administrative problems both for the Government and for taxpayers generally.

Our recommendations for basic depreciation reform have heretofore been submitted to the Ways and Means Committee, by letter to the members on March 2, 1960, and again in oral testimony before the committee on May 17, 1961. For convenience, and, hopefully, for your early consideration, these recommendations are also resubmitted herewith as an appendix to this statement.

APPENDIX

Recommendations relating to depreciation reform

Depreciation allowances under existing revenue laws and administrative practices are wholly inadequate. Outmoded concepts of useful life, particularly as evidenced by failure to give appropriate recognition to the factor of obsolescence, the conceptualistic approach currently being taken in the matter of inclusion of a salvage factor in the determination of depreciation allowances, and continuation of the statutory limitation of the depreciation deduction to an original cost basis, have combined to place industry at a serious disadvantage in its efforts to preserve the integrity of its existing capital.

Although changes in depreciation provisions included in the 1954 Internal Revenue Code were an improvement over prior law, these changes have resulted in the introduction of more rather than less rigidity in administrative practices. Much could be accomplished administratively, therefore, by a more realistic attitude toward the physical facts of today's economy. More importantly, however, further statutory changes are needed. The following are recommended for early consideration:

(1) Provision should be made whereby there is created a statutory presumption of correctness when service lives used for tax purposes are no shorter than those used by the taxpayer in determining depreciation reported in his regular books of account.

(2) Section 167 should be modified to permit a taxpayer to change depreciation methods or rates as the conditions applicable to his business require and he should be accorded the automatic right to shift at his option between the methods available under section 167(b).

(3) Salvage value should be specifically permitted to be excluded as a factor in the determination of depreciation allowances. Collateral to the adoption of such a provision, section 1231 might be amended in such manner that the net proceeds from the sale or other disposition of depreciable assets would be taxed as ordinary income to the extent of the original cost of the assets disposed of. Proceeds in excess of original cost should, however, continue to receive treatment as capital gains.

(4) Provision should be added under section 167 recognizing cost level depreciation. Various methods have been suggested to implement this proposal. We believe the most practical of these to be a procedure whereby depreciation computed on the basis of historical cost would be adjusted in relation to a generally accepted index of the current cost of taxpayer's depreciable property to its historical cost. For practical purposes, and as an element of control where this approach is selected, the actual depreciation allowance should be limited to the amount recognized by the taxpayer in his books of account.

The importance of the depreciation problem cannot be overstated. The national interest demands that early consideration be given to a more realistic approach to this problem and we strongly urge that procedures along the lines here suggested would best serve that interest.

SECTION 3—DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

A close examination of the views presented by the President in his April 20, 1961, message on the disallowance of certain entertainment and travel expenses discloses that the "opposite results" are much more likely to be obtained than the results desired by the proposed legislation.

The need for such drastic legislation has not been shown

A weak and unsound tax system would be encouraged by adding section 274 and amending section 162(a)(2) of the code as it pertains to the elimination of certain entertainment and travel expenses. Over 10 years ago, the Internal Revenue Service recognized that a problem existed with some taxpayers who attempted to "live off the expense account." In 1957 the Internal Revenue Service made an abortive attempt to cope with the travel and entertainment expense problem by requiring certain information on the now famous line 6(a) (they had to forgo this because of timing; the announcement was made too late in the year). During 1959 the Internal Revenue Service held many meetings and finally issued Treasury Information Release No. 198 on December 29, 1959, which gave a detailed explanation of their proposed enforcement program for 1960 tax returns. In April 1960, the Internal Revenue Service outlined in detail in Treasury Information Release No. 221 the information it would request on expense account allowances, deductions claimed that could be construed as entertainment, procedures its agents would follow in examining returns, and instructions directed to the agents. In June 1960 the Senate actually passed a bill disallowing most entertainment deductions. The inequities of such a provision were quickly detected and another bill was substituted directing a study to be made of the expense account abuses.

It is apparent that great activity has been conducted in this field since 1957, but the 1960 tax returns are the first returns that could be expected to reflect any results from such efforts. It would be very weak and unsound thinking to suddenly say that the situation will not be corrected voluntarily by the taxpayer and the added emphasis on enforcement. The President's tax message is supplemented by a voluminous report describing in detail the results of the investigation of "expense account abuses." However, the value of this report is definitely of questionable nature when it is considered that the report covers returns prepared before the taxpayer was even requested to correct his "wayward" ways. The "scope of the report" states, "The returns involved in this study were prepared by taxpayers prior to the initiation of the enforcement program of the Internal Revenue Service announced in Technical Information Release 221, dated April 4, 1960." Legislation that is based upon such obsolete information can only add to the present unsound principles that are woven into our tax system. It could quite properly be classified as "scare" or "hysteria" type legislation. It is not difficult to understand why there is such a growing concern for immediate legislation when one recalls the committee investigation of the "5 percenters" and how expense account abuses became fashionable subjects for cartoonists, columnists, and feature writers. This can be ably illustrated by the large quantity of newspaper clippings that were made a part of the Treasury Department's study of entertainment expense. The average individual taxpayer has been led to believe that the extreme cases he reads about are commonplace and typical, when actually the great majority of companies are quite conservative and do not condone excessive spending.

Travel and entertainment expenses are ordinary and necessary business expenses

The "ordinary and necessary" concept is firmly embedded in our tax structure as well as in the code itself. To abandon this concept under the guise of "loophole" plugging is nothing more than an attempt to subject our economy to more stringent taxation and at the same time substitute Government control for business judgment.

Economic stability and stimulation of growth cannot be promoted by arbitrarily removing business deductions for bona fide entertainment and travel expenses. Such expenses are as much a part of manufacturing or selling a product as the time and material consumed; to deny a taxpayer the right to deduct such "ordinary and necessary" expense would be outright confiscation of his property. If such unwise legislation were to be passed, it would leave the taxpayer with two choices: (1) he could continue to pay such necessary expenses without a deduction, or (2) he could terminate all such transactions. Either course would have sudden and drastic results upon his business and upon the economy of the country. The taxpayer would have no alternative but to increase his selling price; we do not need to dwell on the consequence of such action—the populace is well aware of the dangers of further acceleration of inflation. The President has already made several appeals to industry to curtail such action. Of course, the taxpayer could have chosen the second of his original choices and terminated all the controversial payments. It is difficult to ascertain just

what effect this would have directly on his business; but it is very easy to envision the depressing effect it would have upon hotels, airlines, railways, restaurants, all entertainment enterprises, and other allied facilities too numerous to mention. It certainly would be unwise to legislate deliberately against such a widespread segment of our economy; depressing these industries could only lead to greater unemployment and the need for more and bigger subsidies.

The arbitrary disallowance of any type of business expense such as is here proposed by the Treasury will have greater effect on some taxpayers than on others. Thus some taxpayers will, in effect, pay higher tax rates than others. For instance, retailers do not have nearly as much entertainment expense as wholesalers. Highly competitive products such as cement, steel, and rubber require much greater sales effort than patent-protected products. A wholesaler with many customers will have greater selling expense than one with a few large customers.

The complicated proposals in the President's tax message to define by statute what are "ordinary and necessary" business expenses will give rise to many complex problems for both the taxpayer and the Internal Revenue Service. Identical types of expenditures can be directly connected to production of income in one instance and strictly personal expenses in another; the most difficult problems will arise where there is a mixture of both elements in the same expenditure. Our already overburdened tax courts will be deluged with cases in an atempt to define a reasonable allowance for meals and lodging, and whether entertainment expenses are directly related to production of income and not for good will.

There is nothing immoral or against the public interest in expenses incurred in a supper club, theater, county club, or other place of entertainment. The present tax proposals seem to imply that such is the case and, therefore, places them in a different category from other ordinary and necessary expenses. If fraud is involved, the penalties of the law should be enforced, but the proposals do not stop there; they arbitarily disallow such expenses. The businessman seeking sales is in a much better position than the Government to judge what activities and expenses are essential for his success.

It is emphasized in the proposal that such expenses confer substantial tax-free personal benefits to the recipient. This personal gain has been grossly exaggerated; the expense account is not the advantage that the person who has never experienced an expense account would imagine it to be. The person that must constantly travel or consistently entertain at restaurants, social functions, ect., becomes very tired of this mode of living.

Expenditures directly related to the production of income is a requirement that cannot be proved or disproved in a great many cases. Business and/or government may be able to identify many clear-cut cases that are related to the production of income because they result in a sale of the product. But there are just as many cases that cannot be identified because the sale is recorded only in the client's mind, which cannot be read. A person may not be in the market for your product, but next week—or even next year—he may be in the market and will purchase your product purely because of the way you treated him. The expenses you incurred would be directly related to the production of income, but no one would be capable of proving this fact.

No legislation should be enacted until the effect of the recent 1959 and 1960 enforcement programs can be evaluated

In conclusion, let us remember that our income tax is a self-assessment tax and is based on the premise that the taxpayer is basically honest. If he thoroughly understands exactly what is expected of him, he will make an honest effort to pay his just tax. The travel and entertainment requirements were quite thoroughly explained in 1959 and 1960; time will tell if these new instructions and concentrated enforcement activities of the Internal Revenue Service will alleviate the alleged problem. No drastic legislative steps should be taken until the taxpayer has had an opportunity to adjust to the now clearly defined policy. If legislation is found to be needed at a later date, it must be done in such a manner that it will not cause irreparable damage to our growing economy.

SECTION 5—THE "GROSS UP" PROPOSAL ON FOREIGN DIVIDENDS

Section 5(b) of the discussion draft requires the inclusion as a further dividend in the gross income of a domestic corporation choosing to have the benefits of the foreign tax credit in respect of a dividend from a foreign corpora-

tion an amount equal to the income taxes paid by the foreign corporation attributable to such foreign dividend. This is the principle familiarly known as "grossing up."

Previous testimony

The Ways and Means Committee has heard extensive testimony on this subject. Hearings were held on April 11, 1960, exclusively on the gross-up proposal in connection with the committee's consideration of H.R. 10859 and H.R. 10860. The hearings held from May 8 through June 9, 1961, to consider the President's 1961 tax recommendations also included a substantial amount of testimony with respect to the gross-up proposal.

The Committee on Federal Taxation of the Controllers Institute of America does not believe that it would serve a useful purpose to repeat in full all the reasons developed so ably by witnesses before the Ways and Means Committee as to why the gross-up principle should not be adopted. The taxation committee is in full agreement, however, with much of the testimony presented, and for the sake of completeness of this statement and as useful background for the discussion which follows, would like to summarize here some of the principal arguments presented.

(1) The gross-up proposal ignores the principle that U.S. tax liability is based fundamentally not upon the income by a foreign subsidiary, but upon the receipt of a dividend from the subsidiary. The combined U.S. and foreign income tax rate on foreign dividends is never less than 52 percent. Under the gross-up proposal, the combined tax rates on dividends would exceed 52 percent.

(2) The form of doing business abroad is not selected solely for tax reasons. There are normally legal, operating or nationalistic reasons for doing business abroad through subsidiaries. If the choice were made solely from a tax viewpoint, the branch form might very well be chosen because it has many advantages such as the right to deduct currently operating losses, exchange losses, and expropriation losses, the right to deduct percentage depletion, to make certain elections with respect to depreciation, and others. The gross-up proposal represents an attempt to impose the disadvantage of the branch form of organization without at the same time granting the advantages, or, in other words, to equate two forms of organization which are not comparable and which the gross-up proposal does not, as it should in logic and equity, try to make comparable.

(3) The gross-up proposal presents serious questions as to its effect on our tax-treaty obligations with foreign governments.

(4) In increasing the tax liabilities of corporations operating abroad, and particularly in the underdeveloped countries since their tax rates are likely to be lower than the U.S. rate, the proposal would seem to run directly contrary to the administration's announced aim of encouraging private investment in the underdeveloped countries.

(5) The present scheme of taxation of foreign dividends, including the method of computing the foreign tax credit, has been in effect for 40 years and has been reviewed previously by the Congress and the U.S. Supreme Court.

We should like to add to these, our own analysis of the gross-up proposal and our reasons for believing that it should be rejected.

The discrimination argument

One of the arguments advanced in support of gross up is that the "present method of computing the credit for foreign income tax * * * produces serious discrimination agains investment in the United States." (See statement by Secretary Dillon before Committee on Ways and Means, May 8, 1961.) We believe that this argument ignores the fact that most foreign countries derive a substantially greater portion of their total revenues than does the United States from taxes other than income taxes. (See, among other sources, First National City Bank Monthly Letter, September 1961.) Since taxes other than income taxes are not creditable against U.S. income taxes, U.S. corporations doing business abroad are, under existing law, bearing a greater total tax burden than corporations doing business in the United States. Thus, if any discrimination exists it would seem to be toward rather than against investment in the United States.

The double allowance argument

Proponents of gross up also argue that under the present system of taxation, foreign taxes are allowed once as a deduction and again as a credit and that this double allowance provides an unjustified tax advantage which should be

eliminated. Our analysis leads us to conclude that the source of the tax differential which is in controversy does not lie in any double allowance. If the double allowance per se created the tax differential, it could be expected to do so under any combination of U.S. and foreign tax rates. And yet there is no such differential when the foreign tax rate is at least equal to the U.S. tax rate.

We suggest, therefore, that in analyzing the situation it is not particularly useful to theorize about a double allowance. The real source of the supposed tax benefit from doing business as a subsidiary corporation is the fact that the foreign country chooses to impose a lower income tax rate rather than any preferential provision in the U.S. tax law. This is evident from the following computation:

	Schematic taxation of—		
	Foreign subsidiary	Foreign branch	Foreign subsidiary if gross-up is adopted and foreign tax rate is increased to 52 percent
Income before taxes	100.0	100	100
Foreign tax	40.0	40	52
Net income (in case of foreign subsidiary, assume paid as dividend)	60.0	60	48
U.S. income tax at 52 percent	31.2	52	52
Less foreign tax credit	24.0	40	52
Net U.S. tax	7.2	12	0
Total U.S. and foreign taxes	47.2	52	52

The difference in U.S. taxes and in total taxes in the first two columnns is 4.8. What this represents is the difference between the U.S. tax rate (52 percent) and the foreign tax rate (40 percent), a 12-point differential, applied to that part of the subsidiary's income (40) which is used to pay the foreign income tax. It is thus apparent that the supposed tax benefit arises only in cases where the foreign income tax rate is less than the U.S. income tax rate.

The gross-up proposal says, in effect, that since the foreign country has seen fit to tax the income of its resident corporations at a rate less than 52 percent, the United States should levy a tax on the distributed profits of such corporations equal to the difference, thus imposing the U.S. tax rate on the full income of foreign enterprises.

We question whether this is a proper function of the Federal tax system. If a foreign country chooses to tax its national corporations at a rate lower than the U.S. rate, it should be privileged to do so without interference by the United States. Presumably the foreign rate was established for some good reason, such as minimizing the deterrent effect of income taxes or correlating with other elements of the tax system. If the United States, by unwise changes in its own tax laws, seeks to block the attainment of the foreign nation's objectives, the foreign nation can be expected to change its own tax laws (by adjustment of withholding rates or otherwise) so that without cost to its national corporations, it and not the United States will receive the benefit of the tax changes imposed by the United States.

Effect on tax treaties

The Treasury has objected that a foreign nation cannot change the income tax rate applicable to U.S.-owned corporations without changing the rate applicable to locally owned corporations. This may or may not be true, but it would be expected that in time some way would be found to adjust the income tax rates, possibly by counterbalancing adjustments in other taxes. Or, the foreign nation could simply increase the withholding rate applicable to dividends sent out of the country without having to concern itself with possible effects on locally owned enterprises. The Treasury has stated that any such move would be in violation of the tax treaties. While this may be technically true, it is hardly dispositive of the question because the tax treaties contain a provision for cancellation by either party on 6-months' notice, after which they would have to be renegotiated to be in effect.

It has also been stated that grossing-up would not induce foreign nations to increase their tax rates any more than does the present system of computing the foreign tax credit. Although this may be true in some instances, we doubt that there is justification for relying on this supposition in those cases where tax treaties are in effect which provide for lower withholding taxes on dividends than would otherwise be applicable. To the extent that additional revenues are required by a foreign nation and these can be obtained without imposing additional taxes on local businesses and without adding to the total burden of any taxpayer, it would indeed be surprising if the foreign nation did not take advantage of the opportunity

Thus there can be little doubt that over a period the foreign nations having lower than U.S. income tax rates would have the ingenuity to capture for their own treasuries without further harming local industry the amounts which the United States seek to exact. As a result, as illustrated in the third column above, instead of the U.S. share of the taxes rising from 7.2 to 12, it would decline to zero—hardly an effective means for increasing the Federal revenues.

Revenue effect of gross-up

We believe there are other reasons why the proposed action would in some instances have the opposite effect from that intended, from a revenue standpoint. In cases where the foreign income tax rates are higher than the U.S. rate, the proposed gross-up, in combination with the overall, as distinguished from the per-country limitation on the amount of the foreign tax credit, would reduce rather than increase the Federal revenues.

In addition there can be little question but that the gross-up principle, if enacted, since it would be brought into play only with respect to dividends received, might be just the extra consideration that would discourage the declaration and payment of dividends and thus add to our already serious balance-of-payments problem.

Another little understood point is that under the tax treaties U.S. corporations having a permanent establishment in the treaty country are subject to foreign income taxes on such items of foreign income as royalties, interest, service charges, and possibly sales income unrelated to the permanent establishment, whereas U.S. corporations not having a permanent establishment in the treaty country are not subject to foreign taxes on such items of income. A branch represents a permanent establishment of the parent, whereas a subsidiary corporation does not. The additional foreign income taxes incurred as a result of operating through a branch are, of course, recoverable as credits against the U.S. income tax. Conducting foreign operations through subsidiaries serves to insulate much income from foreign taxes and thus adds to the Federal revenues. To the extent that the proposed change would tip the scales toward branch operation the Federal revenues will be reduced perhaps substantially.

The proposal would also be disruptive of normal relationships established in reliance on the existing structure and could well invalidate some business decisions to which investment funds have been committed. In business planning today, which includes tax planning, nothing is quite so important as certainty—not certainty of making a profit, for this can never be guaranteed, but certainty that the principles of taxation will remain reasonably stable. This is not to stay that no tax changes should ever be made. But changes should not be made merely on the basis of superficially plausible mathematical exercises. The gross-up proposal is an attempt to tax an entity as if it were something else, but only in one of a number of relevant respects. It should therefore be rejected in principle wholly apart from its dubious effect on the revenues. . .

SECTION 6—PROPOSED LIMITATION ON EXCLUSION OF INCOME EARNED ABROAD

Present law

Under existing law, a U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year is exempt from U.S. tax on the income he earns abroad during the period, irrespective of when it is paid to him. In addition, a citizen who may not establish residence abroad but who is present in a foreign country or countries for at least 510 full days out of any period of 18 consecutive months is exempt from U.S. tax on the income he earns abroad during the 18-month period, but only up to $20,000 per year. In harmony with these rules, existing law also provides for extending the same treatment to the recovery via pensions

of employer contributions made while the employee was abroad, regardless of where he is living when he receives his pension.

Discussion draft proposes two changes

Section 6 of the discussion draft proposes two changes in these provisions, neither of which, we believe, should be enacted. The first would place a dollar limitation, not yet determined, on the amount of excludable earned income in the case of bona fide foreign residents as well as those U.S. citizens who are temporarily abroad. The second would limit the pension exclusion so as to require the employee to be abroad both when the employer contribution was made and when the pension is received.

Dollar limitation in conflict with basic purpose of exclusion of income earned abroad

Exclusions for income earned abroad have been in the Internal Revenue Code, in various forms, for over 35 years. They were originally enacted to encourage citizens to go abroad in the interest of stimulating foreign trade and to place them in a position of equality with citizens of other countries going abroad. The extension of the exclusion in 1951 to citizens temporarily present abroad for the specified period was designed to induce engineers, technician, and skilled workmen to go abroad, even though not establishing residence there, to work on projects which might take up to 2 or 3 years to complete.

The proposal to place a dollar limitation on the exclusion of income earned abroad by bona fide foreign residents seems to be at cross purposes with the objectives of attracting high caliber managerial and technical personnel to foreign service. While it can be argued that some type of limitation may be necessary to prevent unwarranted tax avoidance by movie stars who make pictures abroad (although it would seem preferable to treat the disease, namely the high rate structure rather than the symptom), it does not seem desirable to enact a limitation which would serve as a deterrent to bona fide activity abroad in the interest of world trade. Any specified dollar limit has serious drawbacks. At least the discussion draft has not committed itself, as the Treasury did, to the $20,000 limit now applicable to the U.S. citizen who is temporarily abroad, which was established in 1953 and was probably too low at that time even though salary levels of managerial and technical personnel were considerably lower than they are at the present time.

If proposals are adopted which increase the U.S. income taxes of citizens employed abroad, some companies will undoubtedly find it necessary to raise compensation levels in order to induce personnel to accept foreign assignments or to remain on present assignments abroad. In such a case, of course, the Government would stand to lose more from the higher corporate tax deduction than it would gain from the additional individual taxes. Other companies might find it uneconomic to continue certain foreign operations requiring the managerial and technical skill of U.S. citizen employees if they are faced with demands for higher compensation to offset increased personal tax liabilities. Another possible consequence of modification of the existing exemptions is that foreign governments might raise the level of their income taxes on U.S. citizens in order to divert the added taxes to their own treasuries.

Taxing foreign-earned pensions unfair as to past accruals and unwise as to future

The proposal to tax pensions of foreign service personnel unless they remain residents abroad after retirement appears to be wholly lacking in merit and grossly unfair to individuals who have been on foreign assignments for many years in reliance on the present tax provisions. In addition to partially confiscating amounts which have been accumulated under tax exemption assurances contained in existing law, the proposal would discourage future participation by foreign service personnel in qualified pension plans, since there would be a tax advantage to receiving the equivalent of the company contributions currently when the exclusion would be applicable. It seems entirely inappropriate to discourage participation in pension plans and to force foreign service personnel to resort to this means of obtaining exemption from tax on this portion of their compensation, and it also seems unwise to discourage present pension plan participants residing abroad from returning to the United States following their retirement.

President's proposal to restrict exclusion to income earned in less-developed countries wisely rejected

The revolutionary proposal of the administration that only income earned in the less-developed countries be excludable for U.S. tax purposes was wisely rejected in the discussion draft. This proposal was apparently designed to encourage American industry to send its representatives to the underdeveloped areas of the world. We believe such a limitation to be both unnecessary to the accomplishment of this objective and unfair to many companies which have already made substantial investments abroad. Business opportunities will continually arise in both the economically advanced and the less-developed countries, and probably to an increasing extent in the latter. The expanding opportunities in the less-developed countries will provide a natural attraction for American business, as long as the present tax provisions are continued. Moreover, it would be unfair to place a tax penalty on the continuation of existing business activities and the protection of investments already made in countries which are now categorized as economically advanced. It would also seem unwise to enact tax provisions which would serve as deterrents to the free transfer of foreign service personnel among economically advanced and less-developed countries and would discourage the exchange of technical information between the United States and the economically advanced countries by making it less attractive for U.S. firms to engage in business activities in those countries. Furthermore, the enactment of a provision which limited the exclusion to less-developed countries would add an element of uncertainty to the taxation of income earned abroad, as the list of less-developed countries would be changed from time to time by Presidential proclamation. Such uncertainty would surely increase the difficulties which companies are already experiencing in inducing capable personnel to accept oversea assignments.

Moreover, from the revenue point of view, there is serious question as to whether there is much to gain from such a change. In any case in which the levels of the income tax rates in a foreign country are higher than the U.S. rates, the removal of the exemption would merely mean that the employee would obtain through the foreign tax credit the exemption that he now obtains through the exclusion. Higher tax rates are actually a fact in many of the economically advanced countries, and removal of the exclusion with respect to these countries would merely add to the present administrative complexities without producing additional revenue.

On all counts, the proposal to restrict the exclusion to the less-developed countries was ill conceived and wisely rejected in the preparation of the discussion draft. Not only was it subject to the objections set forth under this heading, but, as a more radical change than those proposed in the discussion draft, to the fundamental objection of drastically interfering with the continuing need for expansion of world trade activities and protection of investments already made abroad.

Conclusion

The Committee on Federal Taxation of the Controllers Institute of America strongly urges the retention, unchanged, of the present provisions governing the tax treatment of income earned abroad by U.S. citizens.

SECTION 9—WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

Withholding results in interest-free loans to the Government

It has been said that substantial amounts of dividend and interest income are now escaping taxation. The basis for that statement is not clear; it appears to be an assumption based upon a comparison of dividend and interest payments with reported income, taking into account some assumptions concerning amounts which need not be reported. In view of the substantial increases in investments by nontaxable investment funds, it is reasonable to expect that an increasing portion of dividend and interest income is truly nontaxable. Tax-exempt pension trusts now are reported to be in excess of $25 billion. Funds withheld from the various types of tax-exempt trusts and individuals without tax liability amount to interest-free loans forcibly extracted from taxpayers. This would be an unwarranted action.

Taxpayers' account numbers and mechanization of audit procedures should be sufficient

An intense effort has been made in the last year by dividend and interest-paying entities to inform recipients of the taxability of the income, and it is too early to conclude that those efforts are failures if indeed there are substantial amounts of improperly unreported income. Results of the efforts which have been made recently are not in and they should not be prejudged. The educational program should be continued. The Internal Revenue Service has installed an electronic data processing machine in one district which will enable it to compare reports of interest and dividends paid with individual and corporate tax returns. It expects to extend this system countrywide.

Administration costs of the program outweigh the benefits to be derived

The withholding proposals partially relieve paying agencies from burdens which were visualized when the proposals first received publicity, but sustained effort would still be involved for those agencies in the aggregate. Further, the proposals would add heavily to the work of the governmental agencies—additional bookkeeping, additional refunding, and additional clerical checking of returns. It has been reported that in excess of 35 million refunds a year are now being made. Inasmuch as the Internal Revenue Service has agreed to make quarterly refunds, the number that then would be made would be truly astronomical. Business opposes expansion of Government services and costs. Taxpayers also would have an additional burden not only in return preparation, but in securing refunds. Taxpayers entitled to refunds would, for a time at least, be deprived of funds which are properly theirs and should be available for their use. The additional burden upon the economy would not be negligible and should not be imposed.

Even if it be admitted for argument purposes that a substantial amount of dividend and interest income is improperly escaping taxation, there is nothing in the proposals which would assure correction of the problem unless it is assumed that the problem lies primarily with taxpayers in the low income tax brackets. Taxpayers in the higher tax brackets who may now be willfully omitting taxable dividend and interest income from their returns will find no great compulsion to report such income and pay tax in excess of the 16 percent withheld, and they will not have much greater fear of detection as a result of the proposed withholding process. The improvement in reporting of income which might be expected from the withholding proposals is negligible and does not justify the burden of the procedure.

Summation

In summary then, we oppose tax withholding on dividend and interest income for the following reasons:

(1) It is based upon an unproven assumption that there is substantial improperly unreported dividend and interest income.

(2) Enforcement will be greatly improved with the establishment of Internal Revenue Service mechanization of audit and review procedures.

(3) It imposes an unjustified burden upon the economy.

(4) It will not result in substantial correction of the problem of unreported income, if the problem does exist.

SECTION 10.—INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

The Tax Committee of the Controllers Institute has already protested to the Congress concerning the unnecessary expense put upon corporations by section 6038 as enacted in 1960. In that protest it was pointed out that the information which affects U.S. taxpayers or transactions with U.S. taxpayers has already been available upon audit and can be secured as needed. There is no sense or reason in requiring a report every year on every foreign corporation and all of its transactions with related corporations, both domestic and foreign. In addition, the information includes all transactions no matter how insignificant they may be. We find it hard to understand the substantial penalties provided for failing to comply with the reporting requirements even though it appears that most of such requested information may not be relevant or useful for U.S. tax audit purposes.

Penalties are harsh and unreasonable

We wish to stress particularly the harsh penalties carried by section 6038. The loss of foreign tax credit provided for in the present draft appears not to be confined to the deemed tax of the particular foreign corporation but to the entire foreign tax credit of the U.S. person failing to provide the required information. This goes much further than present section 6038 and may be inadvertent since it was not mentioned in the general explanation of the committee discussion draft. In addition to this penalty, those of section 7203 apply, that is a fine of not more than $10,000 and imprisonment for a year. We submit that these cumulative penalties are fantastically unjust. Particularly is this true when it is realized that all the needed information for a full audit will always be available and can be and is currently being demanded on audits for open years back into the 1940's when there was no counterpart of section 6038 in existence.

Burden of reporting is unjustified

Despite the general protests of business, it is now proposed to extend these reporting requirements to individuals owning 50 percent or more of stock and also to all foreign subsidiaries in a direct chain of ownership rather than only to two levels as now provided for under present law. The Controllers Institute expresses no opinion on individual reporting requirements but continues its protest against the needless expense of reporting year after year for all transactions between all related corporations, domestic and foreign. Inasmuch as the Internal Revenue Service cannot make an audit of a taxpayer from such reports but will have to examine each taxpayer for further information, we believe that there must be some simpler and less costly method for giving the Treasury enough information to know which taxpayers had foreign transactions for tax examination purposes. We believe that several simple questions on the various tax returns would suffice for this purpose. We therefore recommend that the proposal in the revenue bill of 1961 should be eliminated and that existing section 6038 should be repealed. The Government must realize sooner or later that the making of reports is costly. If these reports are not essential they should not be required. It is not an adequate reason for requiring such a report to know that it can be furnished or that a similar report is being furnished to some other Government bureau or that an occasional one out of thousands may satisfy the curiosity of an Internal Revenue Service employee.

Expansion of section 6046 is unreasonable

The revenue bill of 1961 also proposes to revise the requirements of section 6046. The proposed revisions offer an excellent example of the unlimited extensibility of reporting requirements once a foothold of reporting is acquired. This example is one that shows how the original purpose is subverted and a new never-ending process of alleged loophole closing is embraced as the new reason for the more onerous and expensive reporting requirements. The law now requires the reporting of the formation of new foreign corporations. It is required that the report be made on the facts existing within 60 days of incorporation. Ergo, a loophole, because U.S. citizens can forgo becoming directors or officers until after the 60-day period.

However, instead of correcting this small deficiency, it is proposed that whenever a U.S. citizen or resident becomes an officer, director, or owner of 5 percent or more of the stock of a foreign corporation, or acquires an additional 5 percent of stock, he must make a report. Thus a continuous and repetitious reporting of every change in officers or directors of foreign corporations and a constant alertness for changes in stock ownership is to be substituted for the one-time reporting of new foreign incorporations. In all reasonableness what can it profit the Internal Revenue Service to have thousands of reports daily flowing into Washington stating that John Roe has replaced Richard Doe as director or officer of a foreign corporation? And of what significance is a 5-percent increase in stock owned? Such reports are useless, expensive and will engender additional disrespect for Government. We protest strongly against this substantial expansion of meaningless reporting.

TREASURY'S PROPOSED TAX HAVEN LEGISLATION

The proposal injures U.S. business abroad

The Treasury proposals dated July 28, 1961, for new subpart F covering proposed sections 951 to 959, inclusive, continue the meat ax approach in defining tax havens rather than making an effort to carefully define areas in which foreign corporations which are mere "shells" are escaping U.S. taxation. There is no precedent or equity to the Treasury approach which taxes to U.S. shareholders the undistributed profits of a subsidiary. Nor is there any justification for penalizing foreign corporations which conduct legitimate business operations in more than one foreign country. Indeed, most efficient operations are usually obtained when a corporation can operate in more than one country. The fragmentation of foreign enterprises would lead to their death or Balkanization, increased costs, and less net return to the U.S. Treasury. It would adversely affect old as well as newly established businesses without regard to important national interests.

Compliance would be difficult and costly

As financial executives responsible for properly maintaining the books and records of corporations, we wish to stress the practical difficulties, if not impossibilities, of the accounting and reporting problems presented by proposed subpart F.

Referring to specific sections, it will be noted that under section 953(a)(1) tax haven profits may have to be determined on a daily basis or for any given number of days even though profits are normally computed only on a monthly, quarterly and annual basis. In addition, section 953(a)(1) makes no provision as to how these imputed profits are to be ascertained where there are several classes of stock outstanding, or where there are arrearages in preferred stock dividends. How, for instance, are such profits to be attributed to common stock where there are classes of prior preference stock outstanding on which dividends are due? In many cases the laws of the foreign country or the articles of incorporation of the foreign company place limitations upon dividends which can be paid. How can earnings of a corporation which can never be paid out be imputed to the shareholders under a tax system which is supposed to be equitable?

As "undistributed tax haven profits" are defined under section 954(b)(2) it is possible to distribute all of the tax haven profits for a period, yet a portion will be deemed undistributed and taxable. For example, assume the following:

Tax haven profits = $20x$
Total profits = $100x$
One-half profits distributed to U.S. shareholder = $50x$

Under paragraph (2) it is deemed that $10x$ for this year constitutes undistributed tax haven profits. This example illustrates that unless 100 percent of the profits are distributed each year—a thing that no U.S. corporation in active business ever does—the U.S. stockholder will be deemed to have received income that he has not received and may never receive.

Inasmuch as only undistributed tax haven profits are imputed to U.S. shareholders, it would be necessary to maintain separate records as to what portion of accumulated earnings represents tax haven profits and what portion does not. Foreign taxes paid with respect to each would also have to be maintained for tax credit purposes. In addition, if "undistributed tax haven profits" are to be determined on the basis of U.S. law, this might necessitate maintaining two sets of records: one to comply with foreign law and one to comply with U.S. law.

In the definition of a "tax haven transaction" in section 954(c)(1)(A)(ii) an impossible standard is established whereby a tax haven transaction is defined as "the purchase or other acquisition of personal property and its sale to a related person, if such property is sold for ultimate use, consumption, or disposition outside the country" in which the purchasing corporation is created or organized. This would require the tracing of such property to its ultimate use, consumption, or disposition through any number of unrelated corporations or persons. The same objection applies even more to subparagraph (B) concerning commissions covering payment for services performed for a related person in connection with the purchase of personal property, if such property is sold or purchased for ultimate use, consumption, or disposition outside the country under which the foreign corporation receiving the commission is organized. This would treat as a tax haven transaction many transactions wherein a

foreign corporation now acts as a selling agent or a mere referral or service agent for a U.S. corporation if the ultimate use, consumption, or disposition of the personal property to which the sale or service related is outside the country in which the company earning the commission is created or organized. This suggests that it may be necessary to establish selling companies in every country to avoid the penalty U.S. tax. It would be burdensome to require the maintenance of separate records by customers located within and without the country of incorporation of the foreign corporation. However, this burden would be insignificant compared with the work involved in tracing where an unrelated purchaser ultimately used, consumed, or disposed of the property.

Treating all interest received from related persons as tax haven profits under section 954(c)(3) would impair the ability of foreign companies operating in more than one country to use their capital or earnings to finance their business operations in foreign countries except through branches.

The information required to determine tax haven profits is not available to a stockholder having 10 percent ownership. In most cases such information would not be available to a 50 percent owner because the records of foreign corporations are not kept in accordance with the requirements of this proposed subpart F of the United States Internal Revenue Code. The foreign corporation may not provide the required information to a partial owner. It would entail an expense not of benefit to foreign stockholders and they would not cooperate. We can never reasonably expect any foreign corporation having less than 100 percent U.S. ownership to maintain an accounting staff familiar with the United States Internal Revenue Code.

We wish to register our objection to any tax proposal which will hinder or retard American trade anywhere—whether in the United States or in foreign countries. Our Government has generally kept a handsoff attitude with respect to business both at home and abroad.

Multicountry operations does not avoid U.S. tax

Testimony before the Committee on Ways and Means on the President's proposed legislation dealing with foreign corporations shows that multicountry trading by corporations incorporated in low tax rate countries did not result in the avoidance of substantial U.S. tax but was motivated by a desire not to be exposed to the higher tax rates of the foreign country where the goods were to be delivered. We firmly believe that our Government should not interfere in such trade arrangements. Moreover, in the long run it would increase U.S. revenues by reduction in the foreign tax credit.

We are unable to understand the approach taken by the Treasury Department. Inasmuch as this proposed legislation would have a long-range adverse effect on foreign commerce, we wonder what, if any, is the long-range objective of the proposal. Those which conduct bona fide commercial operations should not be penalized for the acts of the few who operate through companies that have no substance.

Conclusion

The Treasury Department now has the power under section 61 of the Internal Revenue Code to allocate income to the taxpayer which earned it. If a related foreign corporation itself performed none of the merchandising functions, then obviously it did not earn the profits attributable to such merchandising operations. The profits would therefore be allocable to the taxpayer which did perform such merchandising functions. In addition to section 61, the Secretary of the Treasury or his delegate has authority under section 482 to allocate income, deductions, credits, or allowances between related taxpayers if he determines such action is necessary to prevent evasion of taxes or to clearly reflect the income of such taxpayers. These are potent weapons at the disposal of the Treasury Department.

We cannot understand the attitude of our Treasury Department in proposing legislation amounting to the imposition of a penalty on shareholders who engage in foreign trading. We oppose such action on the grounds that it would be detrimental to U.S. business. Even if it were not disadvantageous to our country, the problems and the recordkeeping involved in this particular proposal make it objectionable to business.

In addition, the proposed law is at variance with the basic principles of taxation of corporations as separate entities.

Senator CARLSON. Mr. Landolt, you have expressed opposition to certain sections of the pending legislation.

Do you favor any sections or any provisions of the bill?

Mr. LANDOLT. Well, sir, I have mentioned in here that under the scope of our duties and under the policies adopted by the board of directors of the Controllers Institute and, I think, wisely, there might be sections of the code that we would think fair individually. But if they deal with a specific industry and we will name insurance or co-ops, we do not think it is proper for us to take a stand on such things.

Senator CARLSON. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator BENNETT. May I, Mr. Chairman, ask another question?

Are there any sections of the bill on which you can properly take a stand of which you approve?

Mr. LANDOLT. As it affects corporations and as representing the Controllers Institute?

Senator BENNETT. You have said under the rules of your organization there are certain areas on which you might not comment. Now you have listed a number of sections in the bill, and every one of your comments has been a comment of disapproval, as I have listened to your testimony.

Are there any sections on which you can properly comment which you approve?

Mr. LANDOLT. Sir, I am sorry I cannot answer you really either way for this reason: This committee was called into session, we have been devoting very considerable study to it. But, as you may well imagine, at the yearend preparing tax returns, closing books, and getting ready for stockholders' meetings, most of us are pretty well tied up, and involved, and we are not able to devote a whale of a lot of time to this.

This committee met for the last time just a week ago today in New York. The last writeups that I got suggestions, comments, criticisms, et cetera, were received in my office on Monday morning, and it makes it pretty impossible for us to study the entire bill for things that we do not feel that we should properly comment upon, and for me to go down the list now I think would be rather fruitless because I would be speaking for myself rather than the committee in the Controllers Institute.

Senator BENNETT. What your committee did then was concentrate on those sections of which you disapproved, and you did not give any study to sections which you might have approved?

Mr. LANDOLT. Right, sir. It could be implied if there are other sections in here that affect the broad aspect of all the membership of the Controllers Institute, and we have not voiced any adverse comments on them, then we approve them.

Senator BENNETT. Thank you.

Mr. LANDOLT. That would be a fair implication.

The CHAIRMAN. Thank you very much, Mr. Landolt.

Mr. LANDOLT. Thank you, sir.

The CHAIRMAN. The next witness is Mr. Richard H. Swesnik, National Association of Real Estate Boards.

Take a seat, sir, and proceed.

STATEMENT OF RICHARD H. SWESNIK, CHAIRMAN, SUBCOMMITTEE ON FEDERAL TAXATION, REALTORS' WASHINGTON COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS; ACCOMPANIED BY JOHN C. WILLIAMSON, COUNSEL

Mr. SWESNIK. This will take exactly 6 minutes, sir.

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you on behalf of the National Association of Real Estate Boards. My name is Richard H. Swesnik, and I am engaged in the real estate business in Washington, D.C. I am chairman of the Subcommittee on Federal Taxation of the Realtors' Washington Committee of the Association.

The National Association of Real Estate Boards consists of approximately 1,400 real estate boards located in every State of the Union. These real estate boards in turn consist of about 71,000 realtors.

Mr. John C. Williamson, counsel for the Realtors' Washington Committee, is appearing with me today and will assist me in answering any questions you may have.

I am addressing these remarks to that portion of the testimony of the Secretary of the Treasury in which he requests that the bill, H.R. 10650, be amended so as to eliminate all forms of depreciation on real estate other than straight-line depreciation, and in which he further recommends that the Congress increase sharply the tax burden on the sale of such property.

For more than 40 years, excepting a few years when real estate along with everything else was in the doldrums, the Congress has treated gains on sales of real property as capital gains.

In 1954, Congress granted taxpayers an incentive allowance through an extra depreciation deduction. We feel that this has caused an improper result in certain types of cases. Later in my testimony I shall present to you our recommendation—adopted last November by our national convention—to meet this problem. However, Secretary Dillon has not addressed himself to this problem. His radical proposals would not only remove the incentive allowance granted in 1954, but he would also place a new burden on real estate.

The Treasury proposals would seriously impede real estate transactions and construction, would adversely affect employment and the general economy, and would run counter to the central purpose of the pending tax bill.

The principal purpose of this tax bill is to create incentives for new investment in depreciable property other than buildings. A special tax credit is recommended by the Treasury for this purpose. Our industry is not requesting that the construction of new buildings be given this tax credit, yet construction is one of the important methods of creating additional jobs. These buildings cannot be created out of Government subsidies. Investments by individuals and corporations are the most important sources of funds for new construction. Not only are buildings excluded from the proposed investment credit, but the Treasury wants to impose burdens on investments in depreciable real property. The burdens would adversely affect the construction industry which has made substantial contributions to the national economy.

In addition, the major renovation of older properties not only creates jobs but accomplishes the socially important objective of preventing the spread of blight and obsolescence in our urban areas. All of these objectives would be seriously impeded by the proposal to increase substantially the tax on the sale of depreciable real property.

Thousands of individuals have pooled their savings in recent years to make possible the formation of real estate investment trust, partnerships, and corporations holding business and commercial real estate. These investors are allowed to deduct property depreciation in computing their annual incomes. The annual depreciation deduction represents a real loss by reason of the exhaustion, through use, of the property and its component parts such as the electrical and heating systems, air-conditioning systems and elevators.

When the property is sold at a gain, the gain is not attributable to the part of the property that was used up. In fact, the gain is attributable to what is left—most of all, the land.

I submit to you that appreciation in the value of the land is a capital gain whether or not the land is improved by a depreciable structure. The Treasury would leave alone the present capital gains treatment for sales of unimproved land, but would penalize the sale of improved land, solely because in prior years a building on the property has been partly used up.

This distinction between improved and unimproved property is neither logical nor fair. Such a distinction would encourage taxpayers to demolish improvements before selling property, in order to obtain an even greater ordinary deduction, in order to avoid ordinary income taxation on the gain from the sale of the land, and in order to avoid the almost inevitable dispute with the Treasury Department over the allocation of the sales price between the land and building.

I would like to discuss briefly some aspects of Secretary Dillon's recommendations.

Secretary Dillon stated:

> When the depreciation deductions cease to produce such spectacular results, the property is frequently sold.

He also stated that there will be $80 million added to tax receipts if his recommendations are accepted by the Congress. These statements are in contradiction to each other.

In the first place, I don't know how Treasury obtained the $80 million estimate. I do know that many investors will refuse to sell properties if sharply graduated ordinary income tax rates are imposed on the sale. The overall effect of the Treasury proposals would be a loss of revenue because the Treasury would not even collect the capital gains tax which is now being paid upon sale. Instead of selling, the investors would hold their property and continue to obtain the tax benefit of their depreciation deductions.

What makes the Treasury feel that it would gain 5 cents from this proposal—much less $80 million? A conservative estimate by our industry indicates that the Treasury under its proposals would lose far more than $80 million from capital gains taxes which it is now collecting on the sale of real property in New York City alone. The loss throughout the country would be be far greater. In addition, the Treasury would lose revenue from the construction industry and from

all related industries which would be depressed by any federally induced stagnation in the realty market.

We do not have time to go into all of the Treasury's examples in the exhibit to Secretary Dillon's statement, but I feel it imperative to call your attention to certain omissions which should be of particular concern to the Congress.

Under example C (exhibit VI), the Treasury illustrates the relationship between depreciation and nontaxable cash flow in a typical projection. It quotes quite freely from a prospectus. I would like to identify the building. It is the Federal Bar Building, located at 1815 H Street NW., here in Washington; 392 investors invested an average of $3,316 each, or a total of $1.3 million in equity cash above a conservative mortgage of $2 million. Many of these investors are Government employees. They invested their savings in 1959. They are earning approximately 5¼ percent on their dollars but will earn more when the lease commences under the contract. These investors contributed substantially to our local economy and a beautiful building now occupies this site.

The Federal Bar Association has the right to purchase the building from these investors beginning approximately 9 years from now for a price which is $460,000 above the original cost to the investors. The Treasury made quite a point of this fact. If the next 9 years, however, are anything like the last 9 years, the increase as a result of inflation will amount to approximately 12 percent, which, based upon the $3.3 million price the investors paid for the building, would indicate a $400,000 increase in dollar value solely as a result of inflation.

Further, the Treasury has not only omitted any reference to inflation but has also omitted other factors which are typical of many investment properties. The tenants in this building have made many leasehold improvements which are not a part of the building for tax purposes but which could not be removed from the building. Therefore, 9 years hence, if the Federal Bar Association exercises its option, it will be buying an improved building. In addition, there is an increase in the value of the ground in such an excellent location. In 3 years it has increased in value from the purchase price of $76 per square foot to $100 per square foot which such ground would now bring in the open market. You can readily see that in 9 years' time the building may very well be worth $4.5 million, not $460,000, as a combined result of the forces of inflation, improvements by tenants, and an increase in the value of the ground, none of which have anything to do with depreciation.

It is definitely true that the structure itself will in fact be depreciating. Especially in the early years, this building's elevator, electrical, air-conditioning, heating and plumbing systems will be subject to actual physical deterioration.

This depreciation will occur, and cannot be prevented, even though inflation, tenant improvements, or increased land values may during some period increase the economic value of the remaining property.

In my considered opinion, the Federal Bar Building would not exist today if the investors had anticipated the Secretary's present tax proposals.

The economic realities of real estate are such that fluctuations in market value are not a measure of annual depreciation. Significantly, the tax laws have never allowed such a result.

Annual depreciation is designed to recapture capital for the replacement of physically wornout improvements which, whether or not the building is sold, must have reserves set aside for their replacement.

I submit that due to technological changes going on in the construction business—for example, the change from manned passenger elevators to automatic equipment, the advent of the double-zoned air-conditioning systems used in modern apartments and office buildings and indeed the fact that any commercial building without air conditioning is already economically obsolete—that the depreciation now allowed on properties is not excessive. Where there are increases in value they are due to completely unrelated factors.

The National Association of Real Estate Boards has undertaken a study for purposes of submitting its findings in connection with the Treasury's proposal to allow more realistic useful lives in Bulletin F. This study so far indicates that under the standards recently applied by the Treasury to the textile industry, for example, our industry has been much too conservative in computing useful lives for real property improvements.

The Treasury points out (exhibit VI, under item D, an analysis of real estate corporation prospectuses) 11 publicly owned real estate corporations, some of which are taking depreciation allowances at such a rapid rate that they are reflecting losses for income tax purposes. All 11 companies are located in New York City. It is a known fact that New York City is the financial center of the world and the pressure of expansion in that metropolitan area has been tremendous over the past 10 years, which is when most of these corporations were formed. May I respectfully call to the committee's attention the fact that there are no publicly owned real estate corporations in Wheeling, W. Va.; Evansville, Ind.; Milwaukee, Wis.; Baton Rouge, La.; Centralia, Ill.; or in Boise, Idaho. In fact, very few if any, such corporations exist in the country except in New York City.

Further, the Treasury is calling your attention only to winners. It is silent about the losers. It does not make any suggestion of an additional deduction when the property declines in value faster than it is being depreciated. There are billions of dollars worth of properties held throughout the United States that are not being sold for only one reason—there are no buyers. The properties are located in towns which are not booming, and no one wants to invest hard-earned money in cities and States located in depressed areas.

We feel that the Treasury's proposal would constitute unjustified discrimination against real estate investors. On the other hand, we do feel that some problems have arisen as a result of the extra depreciation incentive granted in the 1954 law. In order to meet these problems in a fair manner, 71,000 of our Nation's realtors from 50 States of the Union adopted a resolution at our last annual convention, in November 1961, to prevent the combination of incentive depreciation and quick turnover of properties which is the stock in trade of certain

speculators. We respectfully submit to the committee the following recommendation:

In order to encourage construction and investment in real estate, we recommend the retention of the application of accelerated depreciation, but in order to prevent abuses we urge the Congress to amend the Internal Revenue Code so as to require that property subject to accelerated methods of depreciation be recomputed to the straight-line method on sale of the property within 3 years of acquisition or completion of construction.

I am presenting for printing in the record at this point two appendixes, one setting forth an illustration of the effect of the Treasury proposal on a four-family rental structure, and the other setting forth the legislative history of capital gains and losses with respect to real estate.

I want to thank the committee for the opportunity to make this statement on behalf of the realtors.

The CHAIRMAN. Thank you very much, sir.

(The appendixes referred to follow:)

APPENDIX A TO STATEMENT OF RICHARD H. SWESNIK ON BEHALF OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

EXAMPLE OF THE OPERATION OF THE TREASURY'S PROPOSAL RE CAPITAL GAINS TAX ON REAL ESTATE SALES

The Treasury has proposed taxing as ordinary income the gain on the sale of real estate used in a trade or business or held for the production of income to the extent of the depreciation taken where the property is held for 6 years or less. With respect to real property held for more than 6 years, the portion of the gain taxable at ordinary income rates would be reduced 1 percent per month.

A four-family structure is acquired for $40,000 and held for rental purposes for 9 years. Depreciation deductions reduced the "book value" or tax basis of the property to $30,000. The property is sold for $38,000. Under present law the $8,000 gain is taxable at capital gains rates. Under the Treasury's proposal 64 percent of the $8,000 gain, or $5,120, would be taxed at the higher ordinary rate and only $2,880 taxed at the capital gains rate. For a property owner in the 38-percent tax bracket this means an increase in the tax of $972.80.

APPENDIX B TO STATEMENT OF RICHARD H. SWESNIK ON BEHALF OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

LEGISLATIVE HISTORY OF TAX PROVISIONS APPLICABLE TO GAINS AND LOSSES RESULTING FROM SALES OF REAL PROPERTY

Prior to 1938, the gain or loss on the sale of real property was treated as producing capital gain or loss. See, for example section 206 of the Revenue Act of 1921, which first instituted special provisions for capital gains and losses.

In 1938 the Committee on Ways and Means proposed that the law be changed so that the gain or loss on the sale or exchange of depreciable property should be treated as ordinary gain or loss. This was intended to be a relief provision. The committee, in its report, made the following statement:

"The definition of capital assets is slightly modified so as to exclude from the definition property used in the taxpayer's trade or business, which is subject to depreciation allowances. This, in the great majority of cases, should be of benefit to the taxpayer, since it will allow him to take losses against his ordinary income from the sale of such property." (H. Rept. 1860, 75th Cong., 1939–1 (p. 2) C.B. 728 at 782.)

In the same report, the Committee on Ways and Means made it clear that the new law applied only to buildings and other depreciable property, and not to the land. (See 1939–1 (p. 2) C.B. p. 753.) This distinction emphasizes the intent of the committee to grant tax relief to the owners of real property. The usual situation is that the buildings and other improvements are reduced in value from day to day by reason of usage and the passage of time. The opposite is ordinarily true in the case of land, which in the history of this country, usually increases over any period of time.

In connection with the Revenue Act of 1938, this committee enunciated a principle which is as valid today as then. This is the principle:

"It must be recognized that differences exist in the characteristics of ordinary income in comparison with the characteristics of income from capital gain. For example, no matter how high the rates, a taxpayer always benefits from an increase in salary. On the other hand, there is no tax on the appreciation in value of property unless such appreciation is realized through sale or exchange. Thus, it becomes optional with a taxpayer whether to pay a tax on capital gains, since he avoids the tax by refraining from making the sale. It is the opinion of the committee that too high taxes on capital gains prevent transactions and result in loss of revenue" (1939-1 C.B. (pt. 2) 732).

This same principle caused the original enactment of special provisions for capital gains and losses. In its report on the Revenue Act of 1921, this committee said:

"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are, under the present law, taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit-taking and consequent increase of the tax revenue, have been blocked by this feature of the present law."

Apparently, Secretary Dillon agrees with so much of this principle as applies to mineral property, since he makes no recommendation for ordinary income treatment where the tax basis has been reduced by depletion instead of depreciation.

When the matter was reconsidered by the Congress in 1938, the Senate Finance Committee concurred in the views of this committee (quoted above) with the folowing statement:

"There is an essential difference betwen income derived from salaries, wages, interest, and rents and income derived from capital gains. It is always to the advantage of the taxpayer to receive the first class of income, no matter what the rate of tax as long as it is less than 100 percent. On the other hand, the tax in respect of capital gains is optional—the taxpayer is not obliged to pay any tax unless he realizes a gain by the sale of the asset. There is no tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from a bond in one company to a bond in another company. Thus, an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments. The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate, because it adversely affects the employment situation."

In 1942 the Committee on Ways and Means reconsidered the matter and decided that land and buildings should be treated as capital assets. The reason for this was the difficulty in allocating sales price between the land and the building. The change would have avoided this allocation, and would have taxed the gain or loss on the land and the building as a capital gain or loss. (See H. Rept. 2333, 77th Cong., 1942–2, C.B. 372 at p. 414.)

In the same bill, the committee proposed a different treatment for depreciable property other than real property. This different treatment is that which was subsequently enacted as section 117(j), and which is now known as section 1231 of the 1954 code. Briefly stated, it provides that if the total transactions in depreciable property result in a net loss, the gains and losses which produce the net loss will be treated as ordinary gains and losses; if the transactions result in a net profit, the gains and losses will be treated as capital gains and losses so that the net profit is a net capital gain. The committee's statement of the matter was as follows:

"Under existing law, the gain or loss from the sale or exchange of depreciable property is not treated as a capital gain or capital loss, but as an ordinary gain or an ordinary loss. This rule was originally inserted as a relief provision to enable corporations to have the full benefit of a loss from the sale of machinery, instead of being limited by the capital loss provisions, which would permit it only a certain percentage of the loss. It was felt at that time that the taxpayer should not be denied the full loss because it sold the property at a loss instead of abandoning the property. While this rule provided relief in case a loss was realized, it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer" (1942–2 C.B., p. 415).

The Senate Finance Committee amended the revenue bill of 1942 so as to apply to land and buildings the same rules as this committee proposed for machinery. The House accepted this change by the Senate (1942-2 C.B., pp. 708-709).

The Committee on Ways and Means considered the problem again in connection with the Revenue Act of 1950. The solution of the committee at that time was to treat gains or losses from the sale or exchange of depreciable property and real property used in the taxpayer's business as producing only capital gain or loss. In other words, the committee would have rejected the treatment of any such sale as producing an ordinary loss but would have retained the treatment of all gains on such sales as being capital gains. (See H. Rept. 2319, 81st Cong., 1950-2 C.B. 380 at p. 445.) The Senate refused to accept the House proposal (1950-2 C.B., pp. 520-521) and the House accepted the Senate amendment (1950-2 C.B. 585).

The CHAIRMAN. The next witness is Mr. Augustus W. Kelley, the Proprietary Association.

STATEMENT OF AUGUSTUS W. KELLEY, CHAIRMAN, TAX COMMITTEE, THE PROPRIETARY ASSOCIATION; ACCOMPANIED BY WILLIAM J. STETTER, VICE CHAIRMAN

Mr. KELLEY. Mr. Chairman, my name is Augustus W. Kelley. I appear before this committee as chairman of the tax committee of the Proprietary Association. I am accompanied by Mr. William Stetter, vice chairman of that committee.

I am an attorney and presently employed as tax manager of a corporation which is a member of the association. The Proprietary Association is a national trade organization composed of over 100 member companies, small, medium, and large, representing a gross volume of business—both domestic and foreign—in excess of $1 billion a year. This membership is composed primarily of manufacturers of trademarked drugs sold over the counter without the necessity of a prescription, and toilet preparations.

Today I appear to present the association's views with respect to H.R. 10650 commonly referred to as the Revenue Act of 1962. My presentation is limited specifically to two sections of this bill, namely, section 2 dealing with the tax credit for investment in depreciable machinery and equipment, and section 13 relating to the taxation to U.S. shareholders of the earnings of controlled foreign corporations.

With your permission, Mr. Chairman, a more detailed technical statement setting forth our views on all those provisions of the bill which have significance to our members will be submitted to your committee and to the Treasury Department at a later date. (The detailed statement referred to will appear in the last volume of the printed hearing.)

Despite the fact that the enactment of the investment credit would result in a considerable tax saving to our members we are opposed to the adoption of this section on several grounds:

1. We do not believe the credit will accomplish the purpose for which it is designed, i.e., to stimulate investment in new machinery and equipment.
2. The revenue loss will be substantial and can be ill afforded at the present time.
3. It is an example of discriminatory legislation introducing new inequities into the tax law.

STIMULATION OF NEW INVESTMENT IN MACHINERY AND EQUIPMENT

The theory of the tax incentive in our opinion is based on the false premise that business investments are motivated substantially by tax considerations. In our industry, and we believe it is typical of others, the decision whether or not to invest in new machinery and equipment is based primarily on pure business considerations. Tax factors are at best incidental. Simply stated we are not going to spend $1 just because the Government gives us 7 cents. In our opinion, meddling by the Government with sound business judgment is wrong.

EFFECT ON THE REVENUE

At the present time the Government is faced with large demands on our economy for national defense, foreign aid, the problem of unemployment, et cetera. Faced with such demands, it seems only fair to say that if the budget is balanced it will be most fortunate. No one can accurately estimate the revenue loss that would ensue for the fiscal year 1963 in particular and also for later years if this section is enacted. It is recognized that the loss will be substantial with a disastrous effect on the budget. Of course, the revenue loss can be minimized by cutting the credit still further, but this in turn reduces "incentive"—assuming there is one—and concurrently its effect, if any, in stimulating the economy.

DISCRIMINATORY ASPECTS

1. It favors the large taxpayer with money to spend and does not help the marginal producer.
2. It favors those industries with heavy investment in machinery and equipment and provides little or no benefit to other industries such as those engaged in distribution and retail selling.
3. It excludes real property.

What business would really like to see is a reasonable depreciation allowance under the tax law and an end to the continual controversy over depreciation that the Internal Revenue Service has fostered ever since the days of Secretary Morgenthau.

Periodically, business is castigated for seeking handouts from the Government. The investment credit has already been described in Congress as a subsidy. It is a subsidy which business has not sought but which business has opposed. We predict that the investment credit will be called a loophole when its elimination is proposed as a needed reform or to increase the revenue.

The balance of our statement relates to section 13, dealing with the taxation to U.S. shareholders of the earnings of controlled foreign corporations. We are opposed to the enactment of this provision. Our main objections may be summarized as follows:

1. It is the apparent purpose of this section to discourage U.S. business abroad with the expectation that this will result in more business in the United States and a consequent rise in employment here This result will not follow.
2. The provision would be a "horror" to administer for both the Government and the taxpayer.

EXPORTATION OF JOBS

This is a subject about which we have heard a great deal.

The association can categorically state that the growth of foreign business of its members has resulted in more employment in the United States. Therefore, the curtailment of such business, which would result if this section were enacted, can only result in unemployment in our industry in the United States. By the very nature of things, we cannot do business solely through the export medium. In the first place many of our products are too heavy and, therefore, too expensive to ship; so that we could not meet the price competition in foreign markets via the export route. Furthermore, there are problems of tariff, import, currency restrictions, legal requirements, et cetera, of foreign countries. In substance, we can only meet foreign competition by doing business abroad. We go abroad for business reasons, not for tax reasons. We do not manufacture abroad to serve markets in the United States.

COMPETITIVE DISADVANTAGES

I wish Senator Gore were here.

It is our sincere opinion that if this section is enacted it would place us at a severe competitive disadvantage with foreign-owned businesses operated abroad. Since the administration has admitted that this is not an important revenue-producing provision, there appears to be no reason for the legislation except to force U.S. business to withdraw from foreign operations.

In that connection I would like to depart from my text and use an illustration which will bring the point home. Let us assume for purposes of this illustration that we are doing business in Italy through an Italian corporation. The Italian tax rate is approximately 30 percent. The American rate is, as we all know, 52 percent. This 22-percent differential is a cost item, a very substantial cost item. It means, in other words, that the Italian corporation owned by Italian interests, which pays only 30 percent, can cut us by this 22 percent and, therefore, put us out of business. It is that simple, in my opinion.

It is particularly difficult for us to understand the administration's position when it has been clearly demonstrated that private American investment abroad has provided long-term benefits to the United States, and this business, gentlemen, is business we otherwise would not have. We have to go abroad to get that business. We have reached the markets in the United States to the extent we believe possible. This is not runaway business or anything like that.

Now I would like next to turn to the technical aspects. It is our belief that the proposed legislation represents a radical and unwarranted departure from long-established legal and tax principles and no compelling reason has been advanced by the administration to warrant such radical steps. It is of doubtful constitutionality and completely disregards the longstanding legal principle of the separate corporate entity in that it would tax to the U.S. shareholder undistributed profits of a controlled foreign corporation, profits, I may mention, we may never receive. In addition, it introduces new and unique accounting concepts.

The Treasury has stated that it needs legislation in the field of foreign operations to ease the burden of its agents in the field. To quote from Commissioner Caplin:

It is quite obvious that the Service is compelled to devote endless man-hours in the application of section 482 in cases involving foreign subsidiaries.

If Commissioner Caplin is having problems administering existing law, then the new law will make his task all but impossible.

The foregoing can be graphically illustrated by a reference to some of the new terms used in section 13 such as the following:

(*a*) exclusive formulas and processes;
(*b*) substantially developed, created, or produced in the United States;
(*c*) qualified property;
(*d*) qualified trade or business;
(*e*) nonqualified property;
(*f*) increase in investment in nonqualified property;
(*g*) subpart F income;
(*h*) foreign base company income;
(*i*) net foreign base company income;
(*j*) foreign base company sales income; and last but not least,
(*k*) almost wholly within.

All of these and other terms are new and therefore information with respect to them is not available from ordinary financial records. Hence, amounts applicable thereto will have to be estimated, computed, or determined from some "crystal ball."

Further complexities are added to the situation because the provision taxes the U.S. shareholder on earnings he does not and may not receive. This requires complex provisions to handle the foreign tax credit, and adjustments to the basis of the U.S. stockholder of his stock in the controlled foreign corporation.

Other strange aspects of the bill are:

1. It will encourage industry to do more research abroad in order to develop its patents, exclusive formulas, and processes abroad.

I might add here, gentlemen, the reason for that is that you tax a presumed royalty flowing from one of these patents, exclusive formulas, or proceses, if it is developed in the United States. So, therefore, this bill says, in effect, "Gentlemen, why don't you do this work abroad?"

2. It will encourage the formation of a separate corporation in each foreign country, thereby reestablishing the importance of national boundaries at a time when the United States, in conjunction with its foreign allies, is attempting to eliminate barriers in international trade.

Under this bill, gentlemen, if you had a Panamanian corporation qualified in Venezuela—and I am talking now about a legitimate business corporation operating solely in Venezuela and not one of the newspaper article corporations which have been so played up—if you had a corporation organized in Panama, qualified in Venezuela, it would not qualify as a corporation in which you could make an investment for the purposes of reducing your tax under this bill.

But that same corporation, if organized under the laws of Venezuela, would qualify. Therefore, in our opinion, the only answer to this is to comply with this somewhat ridiculous requirement. You

would have to reform your corporation in Venezuela and this is not an unusual situation. In the situation I give you, the corporate form was adopted for the very simple reason that the laws of Panama are much easier to deal with than the laws of Venezuela, so far as the laws of incorporation and formation are concerned. This compares in the United States to incorporating in Delaware and carrying on business exclusively in some other State.

In conclusion, we believe that section 13 will certainly aid employment in the tax field. Companies will be required to add additional personnel to handle the new accounting and legal problems hereby created. The Government will be required to hire hosts of revenue agents, and the ranks of the independent accountants and lawyers will swell from the influx of new business arising out of this provision.

In conclusion, I would like to restate what has already been stated before; namely, that we are already dealing with a horribly complex tax law.

I have been a lawyer for 15 years in the practice of tax law, and I have never seen anything quite the equal of this new bill.

If serious consideration is going to be given to it, gentlemen, I earnestly suggest for your consideration that it be made part of the tax reform bill which is going to come out in a few months, according to Treasury releases.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Kelley. You have made a very excellent statement.

Senator WILLIAMS. Just one question.

Mr. Kelley, based on your last statement, I understand your reasoning is that the facilities of Harvard have already been strained enough by this administration without putting any further strain on it.

Mr. KELLEY. They have, sir.

The CHAIRMAN. The next witness is Mr. E. S. Hall, Hartford, Conn.

Mr. Hall, about how long will your statement take?

Mr. HALL. I can read the entire statement in 8 minutes.

The CHAIRMAN. Eight minutes? All right.

STATEMENT OF E. S. HALL, SECRETARY, FREEDOM INC., FARMINGTON, CONN.

Mr. HALL. My name is E. S. Hall. I am a research engineer and patent attorney with degrees from Yale and the University of Colorado. I studied economics on a Sheffield graduate scholarship at Yale.

In 1945 a slight change in our Federal income-tax law, the Internal Revenue Code—closing the research-and-development-writeoff "loophole"—caused the licensees under my engine patents to quit their developments. Taxed out of business, I studied the code.

In the next 7 years I testified many times before the tax committees, always suggesting that, instead of trying to correct inequities, plug loopholes, tinker with depreciation, and reform "progressive" rates, the logical thing to do would be to write a new code. July 2, 1949, Chairman Doughton of Ways and Means asked me to write the bill.

Freedom, Inc., of Farmington, Conn., was founded in 1950 to develop the freedom revenue code as a public service.

Freedom, Inc., has outlined what the freedom tax law will do and how to petition Congress on an IBM card the size of a dividend check. As secretary of Freedom, Inc., I represent the millions of taxpayers who are petitioning for enactment of the freedom revenue bill, H.R. 6720.

UNTAX ECONOMIC GROWTH AND OVERBALANCE THE BUDGET

According to Treasury Secretary Dillon, H.R. 10650, the revenue bill of 1962, incorporates most of the recommendations made in the President's tax message of April 20, 1961. Thousands of man-hours and millions of taxpayers' dollars have been and are being spent on this bill. Is this prodigious effort wasted? I believe it is; and all because of false assumptions, two of which were stated in the President's tax message:

(1) This message recognizes the basic soundness of our tax structure.

(2) Moreover, special provisions (loopholes) have developed. * * * Whenever one taxpayer is permitted to pay less, someone else must be asked to pay more. The uniform distribution of the tax burden is thereby disturbed. * * * *Of course, some departures from uniformity are needed to promote desirable social or economic objectives of overriding importance which can be achieved most effectively through the tax mechanism.* [Italics are mine.]

Is our tax structure, the Internal Revenue Code, actually sound? It gives every one of us a headache, discourages investors, saps private enterprise, warps business decisions, makes honest taxpayers dishonest, eats up most of the investment capital needed to replace obsolete tools and start new business (up to 52 percent of profit and up to 91 percent of dividends), causes unemployment and inflation, stunts our economic growth, gives aid and comfort to the enemy, costs too much to administer—and costs too much to reform. If it were sound, it wouldn't need reforming. Why is it unsound?

Isn't it because it was written primarily, not to collect revenue, but to promote "desirable" social or economic objectives? Desirable to whom? Disciples of Karl Marx? Communists and other Socialists? What other conclusion is possible when the code imposes confiscatory double taxes on profits and the "heavy progressive or graduated income tax" advocated in the "Communist Manifesto" to abolish private ownership of capital and "centralize the tools of production in the hands of the state"?

H.R. 10650, the 240-page revenue bill of 1962, if enacted, would add more pages to the 984-page Internal Revenue Code of 1954; it would add many more complications to an already overcomplicated and subversive monstrosity. Would it modernize our tools, create new jobs, stimulate economic growth, spread the tax burden fairly, stop the loss of gold, and improve our balance of payments? It wouldn't even balance the budget. Estimates of the deficit range up to $9 billion.

What to do? Reform "progressive" rates as proposed in the Baker-Herlong bills? No. Congress is not going to "unsoak" the rich as long as employees are independent contractors, receiving neither profit nor loss, and demanding that Congress "soak" the rich.

Yet the situation is not hopeless. All complications and 98 percent of the 1,224 pages of the Internal Revenue Code and revenue bill of 1962 arise from two sources: (1) indirect taxation, the attempt to tax

business; and (2) "progressive" taxation, the attempt to "soak" the rich. A direct and proportional income tax law would have no complications. Written on a few clear pages, it would simply collect the necessary revenue. We need a new tax code based on this sound tax principle, a simple tax code designed to collect revenue.

We need the freedom revenue code, H.R. 6720, a simple and sound alternative to the complicated and unsound Internal Revenue Code, a law that will:

(1) Let employers hire employees as limited partners and be taxed as partnerships, withholding a flat percentage tax on all profits, salaries, wages, and other personal incomes.

(Broadest tax base, the national income running over $450 billion, insures lowest rate: 20 percent yielding $90 billion now; in peace, 10 percent.)

(2) Adjust the tax rate currently to overbalance the budget, gradually retire the debt, and thus restore and maintain the buying power of the dollar.

(The high cost of living will come down in the natural way.)

(3) Let employers distribute the balance of profit (or the loss), in cash dividends declared as usual or in property ownership credited (or charged if a loss), to employers and employees, the amounts proportional to their respective amounts of money invested and year's pay.

(No "double taxation." Comparisons made from annual reports show that, stockholder or employee, you will get a raise, more net personal income. The "facts" will find themselves. No exploitation. No "featherbedding." No strikes. Industrial peace in capitalism. Dividends on the property ownership acquired by employees reinvesting part of their profit, will care for seniority and retirement in the natural capitalist manner, better than pensions, better than socialist "security." Just distribution of ownership of surplus will be always proportional to existing ownerships; it will cause no cumulative change in control.)

(4) Let the needy change from miscellaneous relief to overall security: cash aid, locally administered, for food, clothing and shelter. Pay all their medical bills.

(No special taxes. No accounting overhead. Lowest cost.)

(5) Provide for the general use of farm-income insurance, correlated each year by government, to guide production in the free market.

(The high cost of eating will come down.)

(6) Pay government and other nonprofit employees an incentive from and in proportion to the billions they save and return to the Treasury or other source.

(Cut spending. Save $7 billion, $160 per family, the first year.)

June 20, 1961, Treasury Secretary Dillon told the National Press Club that inflation falls roughly into two categories: wage-price inflation; and supply-demand inflation.

Both wage-price and supply-demand "inflation" are misconceptions arising from the popular delusion that high prices are inflation; they are not. Inflation is an increase in money. Wage-price and supply-demand inflation are not inflation; they are results of inflation. This is clear from the "equation of exchange," the basic equation of eco-

nomics which defines price. Here is that equation in its most understandable form:

$$\frac{\text{Number of units of money exchanged}}{\text{Number of units of commodities exchanged}} = \text{average price of commodities.}$$

Whenever Government increases the numerator, money," faster than business is increasing the denominator, "commodities," the value of the ratio, "price," goes up.

Inflation doesn't just happen; it's a crime—grand larceny—the crime committed by government. By "deficit spending," Government inflates money, steals the value of our dollars, robs us of buying power, robs old folks, widows, and orphans, and then, hypocritically, asks labor and business not to raise wages and prices, and proposes medical care for the aged who, if their savings hadn't been destroyed by inflation, would gladly take care of themselves.

Congress could solve the inflation problem, now and forever, by giving us the freedom revenue code, imposing a flat percentage tax on all profits and other personal incomes, the rate adjusted currently in response to price trends, to keep enough revenue coming in to overbalance the budget, gradually retire the debt, and thus restore and maintain the buying power of the dollar.

Adjusting the tax rate currently in response to price trends will serve as an automatic governor on the price level, more positive in action than adjusting the discount and interest rates. As inflation subsides the demand for higher wages and "protection" will fade. The same wages will buy the same or better standard of living year after year. We can all plan and save with confidence in the future of the dollar, in the future of our country, in the future of our civilization.

When we hire all employees as limited partners and thus remove the cause of the class struggle, peace will come to this war-weary world and the tax rate can be cut to less than 10 percent.

In the meantime, what shall we do with H.R. 10650, the revenue bill of 1962? How would it work, if enacted?

Section 2: A 7-percent or an 8-percent tax credit for investment in new plant? This is just another example of the misuse of the tax mechanism to promote a desirable economic objective; it has no proper place in a revenue law. Yet Assistant Secretary Stanley Surrey has said:

> It is intended to be a permanent part of our basic tax law.

Amazing! First take most of the investment capital needed for economic growth by taxing profits up to 52 percent and dividends up to 91 percent, and then add insult to injury by suggesting an 8-percent investment credit to promote economic growth.

This irrational proposal is the result of working from the false assumption, incessantly repeated by Mr. Surrey:

> We Americans are fortunate that our tax system is fundamentally sound.

As stated above, it is not.

It is amazing, too, that by championing the 8-percent investment credit, the champion loophole closer should be trying to open another loophole for a few, whereupon the many would have to be asked to pay more.

Better go back to sound tax principles and write a new code. Stop taxing business out of business. Untax economic growth, not 7 percent, not 8 percent, but 100 percent, and, at the same time, overbalance the budget with the freedom tax law.

Sections 5, 6, 7, 9, 11, 12, 13, 15, 16, 18, 20, and 21: Close foreign "tax havens"? The very words are an admission that the Internal Revenue Code with its double and progressive taxes on profits has been driving U.S. capital abroad. Instead of trying to tax foreign profits, better tax profits here only once, as personal income, with the freedom revenue code. Every business will be free to operate at home and abroad without regard to taxes. The United States will become the top tax haven of them all.

Sections 8, 10, and 17: Mutual savings banks, etc., mutual insurance companies, cooperatives—instead of trying to "tax the untaxed to relieve the burden on the taxed," better untax the taxed: untax business, untax enterprise, untax economic growth, untax freedom. Tax only the taxpayer, the natural person, the one who pays and pays and has always paid all taxes. Said Adam Smith in the "Wealth of Nations":

> The subjects (not the businesses) of every state ought to contribute toward the support of government, as nearly as possible, in proportion to their respective abilities: that is, in proportion to the incomes which they respectively enjoy under the protection of the state.

Under the freedom tax law insurance companies will be taxed the flat percentage rate on their higher dividend income, the same as any other investor. Banks, too, will benefit, yet government will always collect the necessary revenue by taxing the national income, sum of all profits, salaries, wages, and other personal incomes.

Section 18: Withholding the tax on interest under the code would cost more than the increased revenue. In general, interest on bonds should be taxed, but interest on the savings bank deposits of the people is pitifully small; it should never have been taxed at all. When interest is part of business income, only the profit (after deducting business expense) should be taxed.

Withholding a tax on dividends, under the Internal Revenue Code as amended by H.R. 10650, would be another costly headache. Withholding a single flat percentage tax on profits, salaries, and wages, under the freedom revenue code would be simple and easy for any business, corporate or not.

Section 3: Deduct lobbying expense? At first glance I assumed this was an attempt to repeal the clause in section 501 of the code which denies tax exemptions to organizations like Freedom, Inc., which are "attempting to influence legislation." This clause abridges the right of petition, violates the first amendment, yet it is rigidly enforced to muzzle the patriotic organizations trying to stop communism and other kinds of socialism in the United States.

Section 4: Expense accounts, under the freedom revenue code, will be no concern of government; they will be a matter of honesty within the business. Will property owners and personnel permit a few of themselves to steal from their profits by padding salaries and expense accounts? When all concerned—employers, employees, and government—have the same interest in high profits, the "swindle sheet" will be obsolete.

Section 14: Depreciation arguments are meaningless in the absence of allowance for inflation, for improvements made on the property, and, in the case of real property, for a change, either way, in the value of the land.

In computing capital gains from the sale of business or personal property, the freedom tax law would allow for inflation. Since the tax would be flat rate, not "progressive," there would be no need to spread receipts from sale of property over the years to keep from getting into higher brackets. The distinction between capital gains and income would fade when both are taxed at the same percentage rate.

When all concerned in business—employers, employees, and government—have the same stake in high profits under the freedom tax law, we can keep depreciation, obsolescence, depletion, expense, and other accounts as we please and reinvest profits as we please to keep our machinery and equipment up to date. Government's job in administering the freedom tax law need consist only in spot-checking withholdings of the flat-rate tax on all profits, salaries, wages, and other personal incomes. Tax experts, in and out of government, can fold up their books and go home; they can take cash aid under chapter II of the law, and study for another job: plumbing, automation servicing, space electronics—something useful and productive.

Capitalism, the natural free-market business system resulting in private ownership of businesses, will deliver a decent living to all of us all of the time, under the freedom revenue code. When employers hire employees as limited partners and thus remove the cause of the class struggle, Communists and other Socialists will be left without a mission, left with no wage slaves to liberate. We can set an example of strikeless prosperity in partnership capitalism, expose the folly and immorality of socialism, show Marxists they are victims of the world's worst fraud, and challenge them to abandon their mistaken attempt to socialize the world and join us in the fight for complete economic freedom, goodwill in industry, and peace on earth.

Paraphrasing President Kennedy, I hope every Member of Congress who believes in spreading the tax burden fairly and giving every one of us a raise, and who wants to untax economic growth, modernize our tools, create new jobs, achieve full employment, overbalance the budget, retire the debt, restore the buying power of the dollar, cut the high cost of living in the natural way, improve our balance of payments, and win the cold war, will reject the subversive and unsound revenue bill of 1962, H.R. 10650, and actively support and vote for the sound and simple freedom tax bill, H.R. 6720.

Every man a capitalist. Every business a limited partnership. Every nation a republic with just and simple laws. So organized, we can run our businesses directly instead of by political proxy. Congress will have nothing much to do.

Senator WILLIAMS (presiding). Thank you.

The committee will stand in adjournment until 10 o'clock tomorrow morning.

(Whereupon, at 5:20 p.m., the committee adjourned, to reconvene at 10:25 a.m., Thursday, April 5, 1962.)

REVENUE ACT OF 1962

THURSDAY, APRIL 5, 1962

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:25 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Anderson, Douglas, Gore, Hartke, Williams, Bennett, and Morton.

Also present: Elizabeth B. Springer, committee clerk; and Colin F. Stam and L. M. Woodworth, of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Johnson McRee, Jr., of Georator Corp.

Mr. McRee, take a seat, sir, and proceed.

Mr. McREE. Thank you, sir.

STATEMENT OF JOHNSON McREE, JR., TREASURER AND COMPTROLLER, GEORATOR CORP.

Mr. McREE. Good morning, gentlemen.

My name is Johnson McRee, Jr. I am treasurer and comptroller of the Georator Corp. of Manassas, Va. I am a certified public accountant and was engaged in the practice of public accounting for many years prior to the assumption of my present position.

I mention this because some of what I will have to say derives from my experience in the capacity of business consultant to various types of small businesses. I am pleased to have the opportunity to appear before this distinguished committee.

In my study of the legislation before you, H.R. 10650, I can find little to commend any of it, and nothing to commend all of it.

When I try to relate what I see in this bill, to what I heard Secretary Dillon say in his statement before you on Monday, I get the feeling that we must not be thinking or talking about the same thing. I certainly agree with the Secretary about the connection between tax policy and economic growth.

I must take the position, however, that those persons responsible for the everyday operation of the varied business enterprises in this Nation are in a far better position to provide such growth if the Government and its many regulatory bodies would refrain from tampering with the economy and would control its spending so there could be net tax reduction.

I understand that it is beholden upon Secretary Dillon to sell this legislation, plus amendments which I assume were primarily the product of the Treasury Department minds.

As for me, I just help run an American business and my job in appearing here today is to express to you my views from this background and from the experience I have gained as a business consultant to small business enterprises.

I have not appraised this legislation solely from its dollars and cents effect on my company or companies known to me. I believe that what is good for the economy as a whole would be good for my company, and it is from this basis that I have made my appraisal.

As a general matter, my study of H.R. 10650 gives me no reason to believe that it would make a total net contribution to the well-being of our economy.

To carry the point further, I am unable to comprehend how such legislation could be viewed as a job creator.

It seems to me that under our system any new creation must emanate from increased capital. I don't believe anything new evolves from squeezing the air from one end of a balloon to the other.

The Secretary has placed his case in regard to economic growth and job creation on what he terms the "stimulative effects" of a tax credit for investment. In my opinion, the case he has made is somewhat strained, as compared with other forms of tax reduction.

There are two particular effects of such a gimmick that I regard as definitely detrimental.

First, it is a subsidy and I am opposed to subsidies to business, or to anyone else for that matter. Please, gentlemen, don't lavish upon us, American business, the type of paternal affection which has been given to American agriculture.

Second, this entire bill contains provisions which would tend to vastly increase the already overabundant control of business by a tarantulan Government bureaucracy.

Gentlemen, I believe that American business, if left to its own destiny and given relief from oppressive taxation, will resume its leadership under a free enterprise system in maintaining the United States as the world's No. 1 power. This cannot be done as we drift to socialism, or welfare statism, or centralism. It must be done under free capitalism.

It seems to me that the only effective way to provide the American economy with a proper tax structure is through a downward revision of the income tax rates.

We should now have enough history behind us to show clearly that the graduated income tax with its current confiscatory rates cannot help but stunt economic growth. We should also know by now that no amount of Government spending can do anything to offset this effect—but only to accentuate it.

My company is a growing company. We are prospering because we offer a product which is welcomed in the marketplace. We could meet this demand far more quickly if we were allowed to invest the money we earned in expansion and in improving our product even further.

I believe that our judgment based on experience in operating our business is much better for our purposes in such expansion and improvement than that of the Government in offering us a credit for any

particular machinery and/or equipment investment—so if you will relieve us insofar as is practicable by reduction in the corporate rate, we could, for our part, do far more for the American economy than through use of an investment credit.

I believe you will find this to be the case with any and all virile American businesses.

Businesses which are able to help the economy grow do not need subsidies, and businesses which need subsidies are rarely capable of strong economic growth.

In evaluating the administration's program in the travel and entertainment expense area, I am hit again with the inevitable conclusion that the Government considers itself Robin Hood.

Now, gentlemen, Robin Hood as a folk hero has always appealed to me, but he would not appeal to me either as a corporate executive or a government administrator. He was, in fact, an outlaw.

We are constantly confronted with the cry that our neighbor is not paying his fair share of taxes, and we must do something about it. I have never yet known of any direct benefit I have received by the Government gleening more shekels from my neighbor's pocket.

It would be nice if we could pass laws against dishonest or immoral people, but I am afraid the 18th amendment showed us the folly of such practice. In regard to loophole closing in our tax structure, I would liken the tax laws to a fishnet—when one hole is closed another widens.

On the practical side, I believe that honest businessmen spend for travel and entertainment only that which is ordinary and necessary in the operation of their own businesses. These expenditures differ widely with different business enterprises and with different situations, and I don't believe any attempt, including those in this bill, to generalize in this area can be successful as tax law.

I believe the concept of reasonableness as embodied in the Cohan rule and as applied to situations as they arise comes far closer to individual correct answers. Let's gear our tax program to the honest taxpayer and our enforcement of this program to the dishonest one.

I want to comment briefly on the withholding provision in this bill.

First, I remain convinced that the withholding of tax from any individual, corporation, or other entity before any proof of the final owing of such tax by such entity is basically and morally wrong and very probably unconstitutional.

Because expediency caused us to disregard individual property rights of wage earners sometime in the past does not, in my judgment, give us the right to further infringe on the property rights of these and other individuals with regard to their interest and dividends.

Here again we are told that vast sums are escaping taxation in this area. I have studied the figures compiled by the Treasury and I am left with the impression that such figures are primarily devised for selling withholding on interest and dividends.

Those persons who are escaping taxation fraudulently will find another way to do so. They will convert their investments wherever practical to those which are not covered under the present proposal.

On top of this, the Government is asking for more money to administer such a proposal and yet placing the major burden of collection upon segments of private enterprise.

Under H.R. 10650 gain on the disposition of depreciable personal property and certain other property which is eligible for the investment credit will be treated as ordinary income to the extent of depreciation taken for taxable years beginning after December 31, 1961.

On its face this appears equitable to the casual observer.

However, depreciation taken on property which is a capital asset of a business is unquestionably an ordinary business expense for the period to which it is charged.

Further, when such an asset is disposed of at some later date, as being no longer useful as a fixed asset, this is a capital transaction and should be taxed as such.

Therefore, if we maintain that capital gains treatment apply to capital transactions as spelled out in our tax laws (and I think we should definitely retain that intention) such a transaction should be taxed as capital gains.

As to the Treasury recommendation that this provision be extended to cover real property, we find not only this same factor in evidence but a large inflation factor present in many real property values.

This provision asks that we tax this inflation as ordinary income.

The changes embodied in this bill with reference to foreign income and investment are many and varied. My experience in this field is limited, so my comment consequently will be limited.

But after studying the various sections in this area, I am confronted with the conclusion that the stated purpose could be realized in a much simpler fashion.

If we wish to place American business in a proper competitive position with foreign business, then a reduction of rates upon overall income would be a far more direct and effective approach. Again, I see more problems being created in the name of solving others.

Even if we could say that the net revenue gain or loss from the enactment of H.R. 10650 would be $0 (and I believe this would be the best we can say in this respect), the American public has certainly lost to the extent of the increased Government cost of administering such a program as well as the additional cost upon the pocketbook of American business.

Throughout this bill and the additional recommendations made to you by Secretary Dillon on Monday, I detect a distinct feeling that those people in the Treasury Department who authored the legislation are convinced that they and their counterparts in other parts of our bureaucracy are far more capable of the management of American business through taxation and the regulations thereon than are those persons responsible for the management of individual businesses.

Further, when I reflect on the administrative intricacies evident in this legislation, these authors apparently just want Congress to pass tax legislation and then leave the administration and regulation of the business economy in the hands of the Internal Revenue Service and other administrative agencies.

In effect it seems to me that the administration is saying to the Congress that it should disregard its own experience, wisdom and integrity in the enactment of tax laws and substitute therefor the judgment of its tax control enthusiasts.

Over recent years, I have read and listened to many of the ideas of such people, and it is apparent that these ideas are substantially academic and all too rarely born of practical experience.

Their belief seems to be that if they can call the tune on rearrangement of tax liabilities, the overall tax burden will no longer be a burden on the economy.

Moreover, it seems never to occur to these people that the best way to deal with the tax problem in the American economy is to reduce the overall burden of taxation.

As you know, such a reduction in burden could be achieved simply by stabilizing the level of Federal spending, and returning to the private economy the natural increase in revenue resulting from economic growth.

Such a return, with emphasis on relief where taxes are most destructive as regards capital formation, would mean greater growth in the economy, and in a short time even more revenues.

This, in my view, is the way to enlarge the tax base, not by attempting a rearrangement of taxes which at the best might have little effect as regards capital formation, and at the worst could even add to the total tax burden in this respect.

When a business has a problem, and one course of action after analysis and study does not prove out, we immediately turn our minds to other possible courses. The Federal Government has created its own problem of too much spending, and unwise, restrictive rates of tax. It is clear to me at least that the program set forth in H.R. 10650, or any repetitions of this kind of a program, will not solve the problem.

Accordingly, it seems to me that this committee and the Congress must turn to the consideration of other courses of action which will reduce the drag on the private economy caused by the Federal tax structure.

As you know, such a tax program has been sponsored by Representatives Herlong and Baker of the House Ways and Means Committee (and this program also has been introduced in the record of these hearings, for purposes of discussion by Senator Carlson). I urge with deep conviction your most serious consideration of the course of action set forth therein.

As you might guess, I follow your chairman, the distinguished Senator from Virginia, in his stanch advocacy of economy in the Federal operation. I believe if his views had been followed in the councils of government since World War II and before, our economy today would be on a much stronger and more dynamic basis; we would have no problem of recurring deficits; and our position of economic leadership, prestige and strength in the world would be such that we could laugh at the Communists in this respect.

It is my view that we can no longer expect real economy in Federal operations by using threats of the results of inflation, however sound I believe such arguments to be.

To force economy it seems to me that we must offer the public something which in total is more attractive than continuous increase in public spending. I believe that the program of reform of tax rates and methods, embodied in the Herlong-Baker bills, holds this attraction.

It is readily demonstrable that such an approach to taxation can be accurately and faithfully associated with all of the objectives which the public regards as important today, including:

Greater economic growth.

More jobs and better jobs to the point of eliminating excessive chronic unemployment, and providing solid work opportunities for the young people who come out of our schools and colleges each year.

Greater productivity of the economy, which would reduce inflationary pressures.

An enlarged industrial base to provide greater flexibility in military preparedness over the years ahead.

Restoring the natural competitive strength of the American free economy, which is so necessary if we are to meet the challenge of the European common market as well as the Communist bid for world economic leadership.

Fiscal integrity: One point of which I am sure is that if Congress would enact this kind of a program, it would find tremendous response and support from many diverse groups in America, including the public press.

I hope that these hearings will serve to demonstrate that there is no reason for pessimism about the future of America, if the Congress will lead the way in reducing the dependence of our citizens on Federal spending, and encouraging the independence and expansion of human well being which would come by releasing substantial amounts of capital from taxation.

The CHAIRMAN. Mr. Ree, I want to congratulate you on a very fine statement. You have dealt with fundamental principles that are very important for us to discuss and attempt to follow.

I think what you have said represents the philosophy of a large majority of the Virginia people.

I thank you very much for your presentation.

Senator Kerr?

Senator KERR. I want to tell—Mr. McRee is it?

Mr. MCREE. Yes, sir.

Senator KERR. That I think he has made a very fine statement. I would like to ask a question or two about it if I may.

You say you are treasurer and comptroller of the Georator Corp?

Mr. MCREE. That is right, sir.

Senator KERR. May I inquire the type of business of your corporation?

Mr. MCREE. We manufacture generators and frequency converters, alternators.

Senator KERR. Generators for what?

Mr. MCREE. Generation of electricity, small- and medium-sized variety.

Senator KERR. For what market?

Mr. MCREE. Well, we have a large market. I guess the electronics industry, and certain oil well drilling operations. This would be rather extensive—we don't make the large power transformers, those kinds. We make small ones. Ours is a permanent-magnet-type generator which has no brushes. For that reason——

Senator KERR. Is it a machine for use of small, that is, for those who require standby or small amounts of electric power?

Mr. MCREE. Not primarily. We make such a machine, but ours are for use in areas where dependence and reliability is extremely important.

Senator KERR. I wonder if—is the word spelled correctly, G-e-o-r-a-t-o-r?

Mr. McREE. That is right.

Senator KERR. In other words, it means the same as if there were an "n" in the word.

Mr. McREE. That is right, it would be wonderful if we could convert the name.

Senator KERR. No; I am just trying to understand the type of your business.

Mr. McREE. That is right.

The actual name is "Georator," and also, one of our subsidiary corporations manufactures geological instruments and so the two were kind of put together originally.

Senator KERR. On the second page of your prepared statement in the next to the last paragraph you say it must be done under free capitalism.

I wonder if you would define that term to me as you understand it.

Mr. McREE. Well, I believe free capitalism is the system of free enterprise which allows business and individuals to operate in an area in which supply and demand are allowed to control.

Now, in making a general statement of this kind, there are certain areas which you and I both know that the Government is the only instrumentality which can step in. But by and large, I believe that the free enterprise, free capitalist system, means that we have the freedom to operate in the marketplace and be bound only by the laws of supply and demand.

Senator KERR. What percentage of the business identities in our economy do you think operate in an environment controlled solely by the laws of supply and demand.

Mr. McREE. I wouldn't know how to arrive at such a percentage. I would think it was a little too low.

Senator KERR. Well, for instance, of course, the largest business in the Nation is agriculture. I guess the second largest business is the electric power business, either the third or fourth largest business is transportation.

Do you think any one of those three operate in an environment controlled solely by the laws of supply and demand.

Mr. McREE. Not altogether. Certainly agriculture does not.

Senator KERR. Well, the other two are completely regulated.

Mr. McREE. Well, the public utilities, of course, fall into an area of natural monopoly, and——

Senator KERR. You and I couldn't start a power company and serve Richmond, Va., could we?

Mr. McREE. No; I am afraid not, Vepco might have some objection to that.

Senator KERR. You and I couldn't start a truckline from here to Richmond on the basis of free private enterprise, could we?

Mr. McREE. No; we couldn't. Whether that regulation——

Senator KERR. I was just trying to find out what percentage of the entire economy finances one of the great segments of our economy. You and I couldn't start a bank down at Richmond if we wanted to, could we, just on the basis of free private competitive enterprise?

Mr. McRee. No; but I would think that at a hearing before the State corporation commission if we could present our case for the need of such a bank in the area we could start one.

Senator Kerr. Well, that would be, though, somebody else's decision. It couldn't be accomplished on mine and your decision.

Mr. McRee. That is true. Bear in mind when I said what free capitalism was I said insofar as it is possible and practicable under the laws of supply and demand.

Senator Kerr. Well, with the limitation of insofar as it is practicable and possible, there would be no disagreement between us. If there were any disagreement it would be in the application of the term.

Now, when did your company start, Mr. McRee?

Mr. McRee. About 11½ years ago, as a corporation.

Senator Kerr. Has it been successful in its operations?

Mr. McRee. Yes. Although it went through a period in its very beginning when it had to——

Senator Kerr. Establish itself?

Mr. McRee (continuing). Establish itself in business.

Senator Kerr. It has prospered then under the system of graduated income taxes that we have?

Mr. McRee. We would have done better without it.

Senator Kerr. Well, I would agree with that conditionally if the economy we have, which we recognize is stimulated by the manner, the areas, the places in which Government funds are spent could be provided to us without any taxation and, therefore, if we could have the benefit of the purchasing power available in part by reason of the operation of certain taxes and certain Government controls, and still not have to pay any taxes ourselves, we would be a lot better off.

But we think we have the environment we have in the absence of the Government programs that we have.

Mr. McRee. Well, I believe that if the tax money, which is derived from American business, were left with business, by and large, we would find that that money would be reinvested in either new equipment or in expansion of the business in some other manner so as to create more employment and that stimulus, I believe, would more than offset that which is provided by Government spending.

I don't see how we get anywhere by sending money to Washington and having it returned to us. Something happens to it in between.

Senator Kerr. I must say you are talking about a matter in which you are keenly interested and I am impressed by what you have said.

For instance though, in analyzing my own State, I am aware of the fact that total agricultural and industrial income in Oklahoma in 1932 was less than or in the neighborhood of a quarter of a billion dollars. The situation was pretty tight. I don't know how it was in Virginia.

Today there is a good deal more than that being spent in Oklahoma by the recipients of social security and assistance.

Now, aside from the merits or demerits of the program, those items alone provide more purchasing power in Oklahoma on which Oklahoma business is able to exist than the entire industrial and agricultural income of the State in 1932.

I take it that it is rather basic that no company can increase its productivity profitably beyond the point where it has a market for what it produces.

Mr. McREE. I think that is correct.

Senator KERR. In other words, there has to be purchasing power for any product for the producer of that to do well in producing it and marketing it.

Mr. McREE. Well, Senator, where did this money which you say was received by Oklahomans—where did it come from in the first place?

Senator KERR. I am sure it is a well-known fact that social security comes from the social security trust fund which is derived from a tax on both employers and employees, and that assistance comes from No. 1, in Oklahoma, the proceeds of a sales tax which was enacted by a vote of the people, and No. 2, by matching funds from the Federal Government which comes from the general revenues fund which is secured from the tax structure of the country.

Mr. McREE. So, in other words, the money was originally gotten from other people somewhere.

I noticed you mentioned the trust fund for social security. I wasn't aware there was such a thing. I am sure the Senator doesn't mean—excuse me.

By trust fund, I mean a fund established and operated on an actuarial basis, whereby receipts into such fund would be retained by it and not used to finance any current Government expenditures except present and future social security payments. To invest fund receipts in Government securities seems to me to be tantamount to financing current Government expenditures and consequently voids the normal trust fund term of reference in this respect.

I don't believe I made this position entirely clear to Senator Kerr and hence our apparent disagreement as to fact.

Senator KERR. You didn't know that the social security tax is paid into a trust fund and held for payment of existing and future claims?

Mr. McREE. Senator, I don't believe it is. My impression is that it comes from the general revenues of the Government and the benefits were paid out of total revenues—I could be mistaken.

Senator KERR. That is an error. And I am sure you are glad to have the accurate information.

Mr. McREE. If that is the case. I certainly am, sir.

Senator KERR. Well, again, I want to tell you that I appreciated your statement and was quite interested in your viewpoint.

Mr. McREE. Thank you, sir.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. Mr. McRee——

Senator KERR. Pardon me, I do want to say I share your admiration for our chairman.

Mr. McREE. Thank you, sir.

Senator BENNETT. So do we all on this committee.

Mr. McRee, are you here saying to the committee that all of the parts of this tax bill, all of the proposals in the bill should be rejected? That the whole package should be killed by this committee?

Mr. McREE. Yes, sir; as a package. That doesn't mean that there aren't certain areas in this bill which I think perhaps by themselves

or with some amendment could be good legislation. But I believe that to be the minority sections.

Senator BENNETT. You believe we should not impose any tax on the savings and loans associations or the mutual savings banks?

Mr. MCREE. In that area, I don't believe that particular provision quite hits the point that is necessary.

I don't believe, as you state, that we should not impose such taxes. I think some revision in that area is necessary.

Senator BENNETT. Well, if we kill the bill completely these particular groups will go without taxation for all practical purposes as they have in the past.

Mr. MCREE. Well, it is my understanding that the administration is desirous that the bill be retained as a package together with its recommended provisions.

Senator BENNETT. There never has been a bill that has come before this committee that has been retained as a package without change no matter who sponsored it.

Mr. MCREE. I am glad of that.

Senator BENNETT. And the function of the committee is to analyze the bill, to amend it, to add to it or take from it. I am just curious to find out whether you believe that all of the material in this bill should be rejected out of hand?

Mr. MCREE. Not individually taken.

Senator BENNETT. And not considered separately and each section checked on its merits.

Mr. MCREE. I think that would be proper.

Senator BENNETT. So you are changing your general position. You think we should consider all these separate provisions and act on each one?

Mr. MCREE. Well, my general statement was based on the statement made by Secretary Dillon that they preferred to have this bill as a package, including the amendments as suggested by him.

Now, the only way I knew to oppose this bill was to state that, as I did, I see nothing to recommend all of it, and little to recommend any of it.

Senator BENNETT. What you are saying is if we are required to consider it only as a package we should reject it.

Mr. MCREE. I think that is correct.

Senator BENNETT. But if we are given the opportunity we always have with every other bill, to write it, change it, as we think necessary, you think there may still be parts of the bill that should be retained?

Mr. MCREE. I think that is correct if such sections be properly amended, sir.

Senator BENNETT. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Douglas?

Senator DOUGLAS. Mr. McRee——

Mr. MCREE. Yes, sir.

Senator DOUGLAS. Would you look at your statement?

I take it that you are opposed to all forms of withholding of taxes?

Mr. MCREE. As a matter of principle, I would say so; yes, sir.

Senator DOUGLAS. Then you would favor the repeal of the law for withholding on wages and salaries?

Mr. McREE. Insofar as that could be done practically—I don't think you could do that all of a sudden.

Senator DOUGLAS. But I mean as a matter of principle you would favor that?

Mr. McREE. Yes, sir; I would.

Senator DOUGLAS. How much loss of revenue do you think this would bring to the Government?

Mr. McREE. Well, as I say, as a matter of practice, I think that would obviously have to be taken into consideration. We have this——

Senator DOUGLAS. I mean how much revenue do you think would be lost by the Treasury?

Mr. McREE. I don't know.

Senator DOUGLAS. Many billions of dollars probably?

Mr. McREE. Perhaps. But this doesn't alter the principle.

Senator DOUGLAS. Do you know the estimates of the Bureau of Internal Revenue that between $3 billion and $4 billion out of the $15 billion received in dividends and interest is not reported and hence escapes taxation?

Mr. McREE. I find it hard to determine how they arrived at such information. If they knew this money was escaping taxation it seems to me it would be beholden upon them to try to collect it.

Senator DOUGLAS. It is somewhat difficult to trace down the items.

Mr. McREE. I understand that. I realize there are areas of difficulty.

Senator DOUGLAS. The Treasury determines the total amount by checking tax returns against the dividend payments of corporations, which are a matter of record, and the interest payments, as those are matters of public record, and the amounts stated on the income tax returns for the recipients are a matter of public record, and when they subtract the second from the first, they get somewhere between $3 billion and $4 billion unaccounted for.

In fact, I think it may be $3 or $4 billion. I think that is an estimate.

Mr. McREE. That is by use of the forms 1099 as contrasted with the individual forms?

Senator DOUGLAS. On the last set of returns.

Mr. McREE. Well, of course, I am not in a position to judge how much it would cost to go after those people, but with machine accounting in the stage of development it apparently is and I understand the Internal Revenue is contemplating going to machine accounting, matching these records would not be too difficult under those circumstances.

Senator DOUGLAS. It would certainly add to the administrative work, matching names against names.

But now Congress is sometimes accused of following purely expedient considerations. It has been my observation of my colleagues that they try to follow principle, and I take it you feel that as a matter of principle we should not withhold income taxes on wages and salaries.

Mr. McREE. As a matter of principle; yes, sir.

Senator DOUGLAS. So you would favor the elimination of this requirement over the course of the next, say, 2 or 3 years?

Mr. MCREE. Well, it would depend on how many years it could be done practically. You couldn't bankrupt the Government; that is, if it is not already bankrupt.

Senator DOUGLAS. It is a principle; if you can trust individuals, shouldn't you do it?

Mr. MCREE. As a matter of principle; yes, sir.

Senator DOUGLAS. Now, you have this sentence:

Further, when such an asset is disposed of at some later date, as being no longer useful as a fixed asset, this is a capital transaction and should be taxed as such.

I was a little dubious about the meaning of this. Suppose it is sold at an appreciably lower price than that at which it was purchased. Should this be taken not as a capital gain but as a capital loss?

Mr. MCREE. Well, there are provisions in the code which allow section 1231 treatment where it could be taken as a ordinary loss.

Senator DOUGLAS. And, therefore, charged off against, used as a deduction against future gains or past gains?

Mr. MCREE. That is right.

Senator DOUGLAS. Suppose that the amount of depreciation which the taxpayer has already taken, plus the amount of the loss, exceeds the original cost of capital assets?

In this way there has been a capital gain, hasn't there?

Mr. MCREE. I don't believe—I don't see how the amount of depreciation plus the loss could exceed the total cost of the original.

Senator DOUGLAS. Well, suppose the cost of the equipment is $50,000, the full $50,000 has been charged off as a depreciation account. It's been sold for $10,000. The capital loss is $40,000, and then the capital loss can be used as a credit to reduce the capital gains in other years, so that, in effect, you get $90,000 for a $50,000 asset, isn't that true?

Mr. MCREE. I believe that in the sale of a fully depreciated asset for $10,000 you have to go back to cost so that the depreciated cost in that case would be zero and you would have a $10,000 capital gain. You couldn't have a loss.

Senator DOUGLAS. Suppose under the accelerated depreciation, the full capital value has already been charged off or let us say $40,000 of it has been charged off, and then the $40,000 loss is carried over so an $80,000 credit has been taken on a $50,000 asset.

Mr. MCREE. I am afraid I don't follow, Senator.

In reporting the sale of a fixed asset, you must reduce the original basis of such an asset by any depreciation that has been taken.

Senator DOUGLAS. Well, that is what I was trying to find out. You say that when such an asset is disposed of at some later date as being no longer useful as a fixed asset this is a transaction which should be taxed as such, and I asked you if there was a loss on the transaction that that should be credited? I understood you to say it should be regarded as a loss and could be applied to other gains either in the present, the past, or the future.

Mr. MCREE. That is a tax loss.

What I have reference to here is that under the proposed bill, if I purchase a fixed asset for $10,000 and I have depreciated that asset, say, half, by $5,000, some years later I sell such an asset, that is no longer useful to me, and I sell it for $12,000.

Senator DOUGLAS. Wait a minute, this is a capital gain.

Mr. MCREE. This is a gain.

Senator DOUGLAS. No, I am speaking of where there is a capital loss resulting from the sale. That was my question, when there was a capital loss.

My question is really this: Whether the amount of the capital loss, plus the amount of the depreciation should be credited in excess of the cost of the original, of the original cost of the asset, that is really my question.

Mr. MCREE. Oh, no, no, I don't think I could—I don't think I or anyone else contemplate that.

Senator DOUGLAS. So if you say the full depreciation has already been taken and if there is a loss in the sale that should not be added and credited.

Mr. MCREE. You are referring now to a loss based on the original purchase price without considering depreciation taken at all.

Senator DOUGLAS. That is correct.

Mr. MCREE. No, of course not.

Senator DOUGLAS. Well, I am very glad we cleared that point up. In other words, you don't want more than 100 percent credit.

Mr. MCREE. No, I don't believe so.

Senator DOUGLAS. And this should apply in the field of real estate as well as in the field of machinery?

Mr. MCREE. I think that is right.

Senator DOUGLAS. Buildings—well, you have gone very far in supporting the proposal of the administration really in this respect so far as real depreciable estate is concerned.

Mr. MCREE. I don't think that is quite the case. But I stand to be corrected.

Senator DOUGLAS. Now, you speak of the need to effect economies in our Government. I agree with that. There are some difficulties in finding economies upon which people will agree.

The Senator from Minnesota remarked the other day that nobody is in favor of any specific tax. They all want to be exempt as far as individual taxes are concerned, and everybody is in favor of some particular expenditure. So that in the appropriating and taxing process there is a built-in bias for expenditures and to cut down revenues.

I would like some help as to where we can make these economies. There are about $55 billion in expenditures as I understand it which go for national defense.

Would you reduce national defense from below the present figure of two and three-quarter million troops under arms?

Mr. MCREE. I believe there are areas in the national defense that could be reduced. I am not in position to evaluate each of those areas this morning.

Senator DOUGLAS. Could you mention some of them?

Mr. MCREE. There are certainly excesses in the Armed Forces administration.

Whether or not—no, I don't know of any specific instances right offhand. I am sure if I had time, I could——

Senator DOUGLAS. I worked very hard at this but I think there are, and I want to say I think the present Secretary of Defense is moving in a most intelligent fashion to reduce this and I think the record will show that he has already saved in the last year some $400 million in the handling of purchases and supplies and it is my belief if he is allowed to, as I hope he will be, he will save several millions in the coming year.

I think he deserves a great deal of credit and as the evidence definitely opens on this point I hope you will look at it and if you think of further economies or suggest them, if you approve what you are doing you should support him.

Mr. McREE. I might say that I share your respect for Secretary McNamara.

Senator DOUGLAS. Now, another big item expense is the interest on the public debt which comes to about $9¼ billion.

Some of us have been trying to reduce the interest rate by Federal Reserve operations and competitive bidding on long term bonds and so forth.

Do you have suggestions on how to reduce the interest charges?

Mr. McREE. Well, I would say this: It would appear that withholding on interest would apply, of course, to Government bonds, as I understand it; and people would be getting less yield insofar as such bonds are concerned—if this money, 20 percent of it, is witheld from interest received by them.

Senator DOUGLAS. But may I correct you on this point. The withholding provision does not add any taxes. It merely provides for the more efficient collection of taxes already owed. I think this should be kept in mind.

Mr. McREE. Well, that is true, sir, except that you don't know whether they are already owed at the time you collect them, do you? I mean there are certain individuals who will be withheld from who will, in fact not owe those taxes.

Senator DOUGLAS. You mean there may be overwithholding?

Mr. McREE. That's correct.

Senator DOUGLAS. The bill provides for quarterly refunding of overwithholdings as compared to the annual repayment of overwithholdings in the case of wages and salaries, so the recipients of interest and dividends get a better break than the recipients of wages and salaries do now.

Mr. McREE. That is true, but, of course, it would cost the Government more money to do this.

Senator DOUGLAS. Would you prefer annual withholding rather than quarterly?

Mr. McREE. I don't favor any, sir.

Senator DOUGLAS. I know, but if we do have it would you favor annual returns rather than quarterly returns? It would simplify things very much.

Mr. McREE. It would simplify things but it would also mean the Government was using people's money longer——

Senator DOUGLAS. Would you then favor refunding overwithholdings on wages and salaries quarterly?

Mr. McREE. No, we already have the annual refunding on wages and salaries withheld from people.

Senator DOUGLAS. Well, shouldn't there be equality of treatment as between wages and salaries on the one hand and dividends and interest on the other?

Mr. McREE. I would say there is something to say for that.

Senator DOUGLAS. Yes.

Will you put both on a quarterly basis or both on an annual basis? You don't want them heads I win and tails you lose?

Mr. McREE. No, I don't, but I would prefer not to have them withheld at all.

Senator DOUGLAS. Why don't you suggest that we eliminate withholding on wages and salaries?

Mr. McREE. I am suggesting in that regard that I am opposed to such a thing in principle.

Senator DOUGLAS. In principle?

Mr. McREE. As soon as it is practical in——

Senator DOUGLAS. If you are in favor of the principle why not do it in practice?

Mr. McREE. But we have to take into consideration possible losses of revenue by too sudden a reversal of present practice.

Senator DOUGLAS. Why don't we take into consideration losses of revenues in income and dividends? They are talking about $600 million a year at a minimum and may go as high as a billion.

Don't you think that we should consider that?

Mr. McREE. We have an Internal Revenue Service which is empowered to collect that tax.

Senator DOUGLAS. Why not let the Internal Revenue Service collect the taxes on wages and salaries instead of withholding at the source, let them do it. Why is it that——

Mr. McREE. I think you are coming around to my way of thinking.

Senator DOUGLAS. Why is it wrong with the Internal Revenue Bureau in the case of dividends and interest, but you don't think so in the case of wages and salaries?

Mr. McREE. I have stated I don't believe in withholding in any form.

Senator DOUGLAS. All right. Let's eliminate the withholding tax on wages and salaries.

Mr. McREE. All right.

Senator DOUGLAS. I think you will lose some billions of dollars in revenue in this system, or lack of system, but if there is a principle involved I suppose that should be considered.

Another source of Government expenditure is $5 billion for veterans' benefits, would you reduce those?

Mr. McREE. I think certain veterans' benefits could certainly be reduced; I long have felt that.

Senator DOUGLAS. Such as?

Mr. McREE. Such as subsidies in the nature of benefits which do not come in the class of giving them an opportunity only. Now, I am a veteran and I felt that, after World War II, perhaps we were entitled to the opportunity to those things which we missed because of war service. But I don't believe that we were entitled to be given things because of the fact that we were veterans.

Senator DOUGLAS. Not even for disabled veterans?

Mr. McREE. A disabled veteran is something else entirely. I think he is entitled to those emoluments which are necessary for his well-being, particularly if his disability—his disablement—came from war service.

Senator DOUGLAS. What about medical and hospital care?

Mr. McREE. In the case of disabled, sir.

Senator DOUGLAS. But not in the case of nonservice connected.

Mr. McREE. That is right.

Senator DOUGLAS. You would eliminate hospital care for the non-service-connected veterans?

Mr. McREE. I believe so.

Senator DOUGLAS. You think the American public would follow you on that?

Mr. McREE. I think a substantial number of them would.

Senator DOUGLAS. Do you have a percentage figure which you could apply to the word "substantial?"

Mr. McREE. No, sir; I don't.

Senator DOUGLAS. Do you think it would be a majority?

Mr. McREE. I believe it would be a majority.

Senator DOUGLAS. You think it would be a majority?

Mr. McREE. I don't believe that the average American citizen wants something for nothing.

Senator DOUGLAS. No; but these veterans have served their country, are ill, and say they haven't money enough to pay the hospital and surgical costs of their disabilities even though those are not service connected.

Mr. McREE. This is true; but aren't there many citizens in this country who have served in many ways who may not have been a part of the Armed Forces and yet have the same situation?

Senator DOUGLAS. Are you a member of the American Legion?

Mr. McREE. No, sir; I am not.

Senator DOUGLAS. Veterans of Foreign Wars?

Mr. McREE. No, sir.

Senator DOUGLAS. If you were it would be interesting for you to defend that proposition in meetings of those two organizations.

Mr. McREE. I think I would welcome that opportunity, sir.

Senator DOUGLAS. Another item is the expenditures on space.

Now, it is difficult to know how much it is going to be. The eminent chairman of the Committee on Space is here, Senator Kerr, of Oklahoma, but I imagine they will probably run around $4 billion a year.

Would you cut those down?

Mr. McREE. I think that is an area in which all of our efforts need to be given attention. It is a new area, and whether—I would hesitate to try to cut expenditure in an area that was as new or as important to the development of this country as that seems to be.

Senator DOUGLAS. So you would not cut down on space?

Mr. McKEE. Not at this time, it would be my idea.

Senator DOUGLAS. Do you believe in going to the moon? That would cost.

Mr. McREE. I don't believe in my going to it.

Senator DOUGLAS. Would you be willing to finance it? That would cost $4 billion.

Mr. McRee. I would have to defer judgment on it. The simple trip to the moon, I would say would perhaps not be worth the tremendous expenditure involved unless we can gain other information through such a project.

Senator Douglas. I don't want to pursue this too much further but you can see there are a lot of items involved in this matter.

Mr. McRee. I recognize that, Senator.

Senator Douglas. Thank you very much.

The Chairman. Senator Williams.

Thank you very much, Mr. McRee.

Mr. McRee. Thank you, gentlemen. I have enjoyed it.

The Chairman. Thank you for your testimony.

Mr. McRee. I have enjoyed the appearance.

The Chairman. The next witness is Mr. Lincoln Arnold, appearing in behalf of the American Mining Congress.

STATEMENT OF LINCOLN ARNOLD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr. Arnold. Mr. Chairman, my name is Lincoln Arnold. I practice law here in Washington as a member of the law firm of Alvord & Alvord, but I am presenting this statement as chairman of the Tax Committee of the American Mining Congress. The American Mining Congress has in its membership producers accounting for the major part of the production by the various branches of the mining industry, including coal, ferrous and nonferrous metals, and industrial minerals.

The Mining Congress wishes to express the position of the industry with respect to several provisions of H.R. 10650.

SECTION 3—EXPENDITURES WITH RESPECT TO LEGISLATION

We endorse the provisions of section 3 of the bill, as far as they go. This section allows the deduction of ordinary and necessary business expenses in connection with proposed legislation of direct interest to the taxpayer, but it excepts from this allowance expenditures in connection with any attempt to influence the general public. It is our position that this section should be broadened to include all lawful expenditures with respect to legislation which are ordinary and necessary business expenses, and we hope you will amend this section of the bill to make it as broad as H.R. 640, introduced by Congressman Boggs, and H.R. 925, introduced by Congressman Byrnes.

SECTION 4—DISALLOWANCE OF CERTAIN BUSINESS EXPENSES SUCH AS ENTERTAINMENT

The members of our industry feel strongly that section 4 of the bill, considered together with the report of the Ways and Means Committee, is much too severe in the disallowance of legitimate business expenses. We do not object to the limiting of traveling expense deductions to a "reasonable amount," and we do not object to some dollar limitation on business gifts. Further, we raise no objection to the overruling of the "Cohan rule," but we believe that the recordkeeping requirements in and of themselves will eliminate the bulk of the "abuses" which exist, and we think Congress should go no further than that at this time.

We assume that the desired objective is to eliminate the deduction of personal living and entertainment expenses under the guise of business expenses. If this be true, the recordkeeping requirements of section 4 should be ample to accomplish that objective. Those requirements are far reaching. The bill provides that no deduction shall be allowed—

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) *the business purpose of the expense or other item,* and (D) *the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift.* [Emphasis added.]

With these safeguards, and with the improved administration which is easily attained under these safeguards and under the changing attitude of the courts toward entertainment expenditures, there is no need to do anything further in this respect. It is difficult to see how personal living expenses could be deducted under this provision. Certainly there is no reason to state, as the Ways and Means Committee report does, that expenditures which are solely for business goodwill shall not be deductible in the ordinary case.

The report of the Ways and Means Committee appears to go much further than the language of the bill as passed by the House. Expenditures which are made solely for the purpose of promoting business goodwill clearly do come within the term "directly related to the active conduct of the taxpayer's trade or business." Yet the committee report indicates that entertainment expenditures will not be allowed unless there is an opportunity to conduct business affairs or carry on negotiations or discussions relating to business affairs. The tax law has long recognized "goodwill" as a business asset, and Congress should not now prohibit the deduction of expenditures for maintaining that asset as required by sound business practices.

SECTION 14—RECAPTURE OF DEPRECIATION ON DEPRECIABLE PERSONAL PROPERTY

We are glad to see that the "recapture" of depreciation at ordinary income rates does not apply retroactively, that is, does not apply to depreciation deducted in the past. We are also pleased to see that it is coupled with a "salvage value" provision that will eliminate many pointless controversies between taxpayers and the Internal Revenue Service. We believe the bill could go further and completely eliminate salvage value with respect to assets acquired in the future to which the recapture provisions apply.

We have a minor technical amendment to suggest in the salvage value provision. The bill provides that taxpayers may ignore, for salvage value purposes, an amount which does not exceed 10 percent of the basis "as of the time as of which such salvage value is required to be determined." There are some circumstances where salvage value is required to be redetermined at a period later than acquisition as, for example, when useful life of the asset is redetermined. In such circumstances, we think the intent is to allow the taxpayer to ignore salvage value to the extent of 10 percent of the original basis to him. We fear the language of the bill might result in allowing him to dis-

regard only 10 percent of the basis adjusted to the date of redetermination.

In connection with the provisions for recapture of depreciation allowances, we also want to call to your attention a point of peculiar interest to the mining industry. The courts have held that in computing taxable income from the property for depletion purposes, the losses from the sale of mining equipment are taken into account but the gains from such sales are not taken into account. As a matter of fairness, if losses on such equipment constitute a cost of mining, then gains from the sale of such equipment should constitute a reduction of the cost of mining. Under the present law, which grants capital gains treatment of such gains, the inequity against the mining industry is somewhat mitigated. Recapture of depreciation at ordinary income rates will accentuate this inequity. We therefore ask for the adoption of an amendment to provide that the amount treated as ordinary income on the sale of mining equipment will be taken into account in determining taxable income from the property for depletion purposes. We would suggest that this can be done by the addition to section 613(a) of the code of language substantially equivalent to the following:

In computing the taxpayer's taxable income from the property, the expenses of mining shall be reduced by an amount equal to the amount which is treated as ordinary income under section 1245 on the disposition of mining equipment used in connection with the mineral property.

Provisions dealing with income earned in foreign countries—particularly sections 6, 12, 13, 16, and 20:

SECTION 13—CONTROLLED FOREIGN CORPORATIONS

On behalf of the mining industry, we wish to express vigorous opposition to the enactment of the provisions contained in section 13.

During the 86th Congress, the Ways and Means Committee reported out H.R. 5, which was designed to equalize competitive opportunities abroad of U.S. companies—that is, the bill was designed to equalize the opportunities insofar as Federal income taxes were concerned. We believe the approach of H.R. 5 as reported out by the Ways and Means Committee was correct. Section 13 of H.R. 10650 goes in the opposite direction of H.R. 5. Section 13 will greatly decrease, rather than increase, the exportation of American economic influence.

Section 13 contains so many complicated, overlapping and confusing requirements that we believe it is completely unworkable. It requires allocations and accounting determinations that would be extremely difficult and costly under the most ideal circumstances, and it is fantastic to assume that operations abroad are accompanied by the advanced accounting facilities which would be needed to obtain the data required by the proposed provisions.

The defects in section 13 appear to be too serious and too numerous for correction; the section should be eliminated in its entirety. For example, the section imposes a tax on the undistributed profits of controlled foreign corporations, without making any provision for deduction of losses. Again, it contains no provision permitting the foreign corporation to elect U.S. domestic corporation tax treatment including permission to file consolidated returns. Under proposed

section 953(a)(2), a U.S. citizen could be taxed on undistributed profits of the foreign corporation, merely because he increased his stock holdings during the year, even though the foreign corporation did not increase its investments during the year in nonqualified property.

"Qualified property" is defined as including money which is ordinary and necessary for the active conduct of a qualified trade or business. Many foreign countries limit the amount of earnings which may be repatriated during the year—is the excess over the permissible amount "qualified property"?

Section 13 in effect gives the revenue agent power to impose upon the taxpayer his judgment as to the reasonable needs of the business. If the taxpayer is accumulating funds for the purpose of planned expansion, the agent may consider such funds to be nonqualified property pending actual investment in the contemplated expansion. Further, it seems clear under the language of section 13 that a taxpayer planning such expansion would be required in any event to keep idle the funds being accumulated for permissible expansion in order to keep such funds from becoming nonqualified investment.

Many U.S. business corporations will be unable to determine whether they have invested in "controlled" corporations. For example, in many countries it is customary to issue "bearer" shares of stock, and in some cases the stockholder will find it impossible to determine who are the other owners of stock. Even where "bearer" shares are not used, the U.S. stockholder does not have the right to force the divulgence of information with respect to the ownership of the other shares.

The taxation of U.S. citizens on the basis of undistributed profits of a foreign corporation constitutes an indirect method of doing something which the United States cannot do directly—we cannot levy a direct tax on foreign earnings of a foreign corporation, nor can we force a foreign corporation to distribute its profits in the form of dividends.

Doing these things indirectly will quite naturally cause considerable resentment on the part of foreign countries, and they can be expected to retaliate. Particularly in the case of foreign corporations which are owned in part by U.S. citizens and in part by citizens of other countries, this law will be regarded as an unwarranted attempt by our Government to control dividend policies of corporations outside of our jurisdiction. In this respect, section 13 conflicts with other efforts of our Nation to maintain international good will.

Further, taxation to the stockholder of earnings not made available to him is a dangerous precedent—the mere fact that the foreign corporation is at least 50-percent owned by American interests doesn't mean a 10-percent stockholder has the power to compel dividend distributions or that he will even be consulted on dividend policies. Even where a U.S. taxpayer is the majority stockholder in a foreign corporation, considerations of amicable relations with his foreign coowners will frequently keep him from altering the dividend policy of the foreign corporation.

Section 13 involves a far-reaching problem which affects American taxpayers on a scale much larger than the small amount of increased revenues which would be obtained from taxing undistributed earnings

of foreign corporations. More than 15 years ago it was wisely decided that American taxpayers could not bear forever the burden of sustaining the economy of the free world in the struggle against aggression. For many years the official policy of the Government has been to encourage private enterprise in helping to develop the economy of free countries, in order that the direct-aid load on the American taxpayers could be lessened. "Trade, not aid," has been the official objective of the Nation. We believe that policy is correct. The prestige of the United States must be maintained in foreign countries, and the economy of the free world must continue to advance toward self-sufficiency. We cannot continue to increase the existing heavy tax burdens on our economy, yet this appears to be inevitable unless other nations will share the burden of sustaining the free world. To help us with that burden, those other nations must have developed economies, and the provisions of section 13 are designed to penalize American enterprise in its efforts to carry out the national policy—a policy still being advocated by the State Department and the Commerce Department, if not by the Treasury Department.

The extraction of natural resources differs from ordinary business operations in many respects, and one of these differences is that a mining company has little choice of location—it must go where the mineral is located. In recent weeks there have been statements made to the effect that natural resource operations would not be much affected by the provisions now contained in section 13, for the alleged reason that domestic companies are usually utilized in lieu of foreign corporations. In some respects, of course, domestic corporations engaged in the production of minerals abroad have tax advantages over foreign subsidiaries—but unfortunately it is frequently necessary, as a practical matter, to use foreign corporations for the extraction of natural resources. Many foreign countries impose an absolute requirement that the corporation be formed in those countries, while many others impose restrictions and requirements that make the use of a foreign corporation a practical necessity. Section 13 severely penalizes the use of foreign corporations, and it must be kept in mind that development of mineral resources will occur in the areas where these resources are situated, whether under U.S. direction or under the direction of interests which may be inimical to us. We think it is far better for the United States to allow our people operating in foreign areas the same tax treatment which is allowed by other nations to their enterprises operating abroad. Without such equal treatment, we will be severely handicapped in our efforts to compete with the enterprises of other countries.

It should be kept in mind, too, that in many instances section 13 will result in less U.S. revenue. In some countries it seems inevitable that the effective tax rate on U.S.-controlled corporations will be increased as the result of this legislation—increased to the effective level of our U.S. tax, so that the net result of this legislation will in such instances be a higher tax by the U.S.-controlled corporation to the foreign country, without any increase in U.S. tax receipts.

The declaration of policy adopted by the members of the American Mining Congress in Seattle in September 1961 contains the following statements:

> The income tax laws of the United States should encourage the economic development of underdeveloped countries by private capital, rather than through the use of Government funds at the expense of our taxpayers. Profits of foreign subsidiaries should continue to be taxed only when they are distributed, and attempts to eliminate so-called tax havens should not penalize legitimate foreign business which is beneficial to the U.S. economy. Where protection of domestic production against imports is necessary, it should be provided by means other than a differential treatment in the income tax laws.

Section 13 of H.R. 10650 is directly contrary to the expressed policy of our members, and we therefore urge that it be deleted in its entirety.

SECTION 6—ALLOCATION OF INCOME WITHIN A RELATED GROUP WHICH INCLUDES A FOREIGN ORGANIZATION

Section 6 provides, in general, guidelines for allocation of income from sales of property within a group where at least one is a domestic organization and at least one is a foreign organization. Even with the rather detailed rules set forth in this amendment, it is quite possible to have more than 100 percent of such income taxed by the United States and the foreign country.

We request the addition to this section of a provision to the effect that where the foreign organization participating in the sale or purchase is in a country which has a tax rate equivalent or nearly equivalent to that of the United States, and the sales price has been determined for the purpose of computing the tax in such foreign country, there shall be a presumption in the taxpayer's favor that such sales price is correct for U.S. tax purposes.

A provision to this effect would do away with taxation in many cases of more than 100 percent of the income involved, and would eliminate costly duplication of allocation disputes.

SECTION 12—REDUCTION OF TAX EXEMPTION FOR INCOME EARNED IN FOREIGN COUNTRIES

Even with the tax exemption provided under present law for income earned abroad, the mining industry finds it difficult to induce qualified executive personnel to go abroad. It is to the advantage of the United States as well as the business involved to have competent executive personnel in charge of the operations abroad, and the Mining Congress believes section 12 should be eliminated from the bill. If it is not eliminated, it will increase the cost and lower the efficiency of operations abroad.

SECTION 16—LIQUIDATION OR SALE OF STOCK IN CERTAIN FOREIGN CORPORATIONS

In general, section 16 taxes as a dividend, to the extent of accumulated earnings and profits, gain from the sale of stock in a controlled foreign corporation and gain upon the liquidation of a controlled foreign corporation. We believe as a matter of fairness such treatment should not be imposed with respect to income accumulated prior to 1962.

SECTION 20—REPORTING REQUIREMENTS

Section 6038 of present law gives the Secretary of the Treasury authority to require reporting of vast amounts of information with respect to foreign corporations controlled by American corporations—including not only detailed information conforming to the U.S. tax system but also detailed information with respect to thousands of minor transactions between foreign corporations which could have no conceivable impact upon the liability for U.S. tax. This provision was not the subject of public hearings, and taxpayers never had a chance to express their views thereon before Congress. However, when the Treasury held hearings on the proposed regulations under this section, taxpayers made an impressive presentation against the imposition of the onerous burden of compliance. To conform accounting statements of foreign corporations to U.S. tax concepts requires the presence in foreign countries of U.S. tax experts, without any concomitant benefit to the United States.

Nevertheless, section 20 of H.R. 10650 not only reenacts this requirement, but actually extends it. Under section 20 this information can be required of individuals as well as corporations. In addition, the Secretary is authorized to require of both corporations and individuals the furnishing "of any other information which is similar or related in nature to that specified in the preceding sentence."

There seems to be developing throughout the Federal Government a concept that can best be described as "the unlimited extensibility of reporting requirements." Adherents of this concept seem to feel the Government is completely justified in requiring the unlimited expenditure by business of talent, time, and money, in order to satisfy the curiosity of anyone in Government. There seems to be no realization that the economy as a whole must bear the cost of the vast army of workers already engaged in shuffling papers to meet reporting requirements.

We believe that the reporting requirements of present section 6038 should not be enlarged—they should be restricted to that information which is reasonably necessary to enable the detection of tax avoidance. Further, the extraordinarily harsh penalty should be reduced. The penalty for failure to furnish information with respect to any corporation is loss of at least 10 percent of the foreign tax credit applicable to all foreign subsidiaries. The penalty, at the most, should apply only to the tax credit arising from foreign taxes deemed paid on income of the foreign corporation with respect to which the failure to report occurred—and even then, it should be reduced in amount. The penalty should not be imposed in any case if it is shown that the failure to comply is due to reasonable cause.

Subsection (b) of section 20 of H.R. 10650 amends section 6046 of the code to require that certain reports be filed by each U.S. citizen who becomes an officer or director of a foreign corporation. We do not object to the change in present law in order to reach situations where no U.S. citizen is an officer or director for the first 60 days of the existence of such corporation. The proposed amendment, however, goes unnecessarily far—there is no need to require these reports every time a U.S. citizen replaces another U.S. citizen as officer or director of a foreign corporation. It is sufficient to reach the an-

nounced Treasury objective if the amendment were merely to require such reports of U.S. citizens becoming officers or directors when no such reports have previously been furnished by other persons.

On behalf of the mining industry, we express our appreciation for the opportunity to express our views.

The CHAIRMAN. Thank you very much, Mr. Arnold. That was a fine statement.

The next witness is Mr. G. D. McEnroe, Halliburton Co.

Senator KERR. Mr. Chairman, if I might be permitted to say a word I would like to tell the committee that this is a very fine constituent of mine from Oklahoma, a man who represents one of Oklahoma's great industrial enterprise, which was born in Oklahoma and which has grown to a position of considerable significance in the Nation and of great significance to Oklahoma and I am happy to tell the membership of the committee that Mr. McEnroe is one of our esteemed Oklahoma citizens.

The CHAIRMAN. We are glad to have you.

Senator DOUGLAS. What product does the Halliburton Co. produce?

Senator KERR. Halliburton is a company that renders a service of cementing casing in oil wells primarily. They have diversified and have other operations but that was the basis of their formation, and has been the basis of their growth and worldwide operations, really.

The CHAIRMAN. You may proceed, Mr. McEnroe.

STATEMENT OF G. D. McENROE, TREASURER, HALLIBURTON CO.

Mr. McENROE. Mr. Chairman, Senator Kerr has already told you my name is G. D. McEnroe, and I am treasurer of the Halliburton Co. of Duncan, Okla.

I am glad to have the opportunity to appear before this committee, and hope that my comments on H.R. 10650 will prove of interest and value to you.

Normally, we think of tax legislation as having some specific and identifiable purpose, such as increasing revenue, or reducing taxes (which might not decrease revenues for long) or revision of the tax law in accordance with experience in living with particular provisions of it.

Except for the provisions in regard to taxation of co-ops, of mutual financial and insurance institutions, and the deduction of expenses in connection with the influencing of legislation, H.R. 10650 does not seem to fit within any of these standard categories.

Instead, it seems to be designed to serve a medley of objectives; namely, substitution of Government judgment for business judgment and for the free operation of the marketplace; a sort of nationalization of foreign business operations; and in general to change things for the sake of changing them.

We live in a time when the total burden of Government is so great that even the most perfect tax system probably would not prevent the total from having some dampening and restraining effect on the private economy.

As it is, in terms of rates and uses of tax methods, the system is strongly biased against saving and investing, or capital formation. This means that it is biased against the most efficient operation of the private economic system.

This in turn means that the structure as a whole prevents the private economic system from progressing as rapidly, and from providing the volume of good job opportunities, which would be possible under a more reasonable use of rates and methods.

In the past, this philosophy has been defended as protecting people in lower income circumstances from payment of taxes, but it is obvious that it also prevents these same people from having the opportunities for employment and advance in living standards which would result from greater aftertax income of business and people in the higher incomes.

It is indeed a poor service to the man who needs a job, or a better job, or a new college graduate, to tell him that he doesn't have to pay the high tax rates which are imposed on the incomes of successful people, when it is such tax rates which drain off the potential capital which would provide more jobs and better jobs and, perhaps, eliminate chronic unemployment as a domestic problem. In terms of human well-being, our tax structure is very shortsighted in this respect.

Over the years, in my opinion, Congress has done a good job of softening the impact of the high rates whenever a good case could be made on the grounds of economics, or accounting, or business practices, that some special provision was justified and in the public interest.

With the greater knowledge today that capital is the wellspring of human progress and betterment, I, for one, also believe that Congress would in this period proceed to substantial moderation of tax rates and methods which hold back our progress and national strength, if political leadership should give the nod in this direction.

But certainly there is no such promise in H.R. 10650, or the statement presented before you on Monday by the Secretary of the Treasury. Instead, the view reflected seems to be that Congress has been wrong in nearly everything it has done heretofore to adapt tax law to the realities of business operations, that the job to be done now is to correct the mistakes of the Congress, and that by correcting these mistakes enough revenue can be picked up to make other changes in the tax law which will contribute to economic progress.

To me, this seems a farfetched scheme, which could well—if followed by the Congress—end up with a tax system which as a whole might be even worse than the present, but certainly not significantly better, as regards the operation of our private business system and its contribution to our national progress, the improvement of living standards, and our national strength.

Perhaps, my overall feeling in this respect is that this whole exercise involves a tremendous waste of time, and has even more serious implications to the extent that it postpones consideration and action upon the fundamental problem of uneconomic tax rates and methods.

The great sellpiece of H.R. 10650 seems to be the proposed tax credit for investment. I doubt if there has ever been any proposal in the taxfield more overrated in terms of its contribution to economic activity than this credit.

In the case of my company, its tax savings would amount to about 1½ percent of its anticipated 1962 income tax—or a drop in the corporate tax rate of about 1 percent.

After all, the maximum amount of overall tax savings involved approximates that which would come from a 2- or 3-percentage point reduction in the rate of corporate tax.

In my opinion, the economy would derive more good out of such a reduction than it would from the credit "gimmick" as I believe you have called it, Mr. Chairman. But certainly no one would seriously contend that a 2- or 3-percentage point reduction in the corporate rate would provide the Nation's economic salvation. The whole tax picture has been distorted, and our real tax problem obscured, by the emphasis placed on the proposed credit.

I think it is unfortunate that because the credit is in the nature of a subsidy, the attack of some upon it has stressed such words as "bonanza" for business. The fact that the credit would provide tax relief for business is not what is wrong with it; that would be good.

It is the fact that it is the wrong way to provide relief, that taking our total business operations it is very small relief indeed, that the relief would be afforded in a way which would be discriminatory as between businesses, and that its enactment undoubtedly would be used as a precedent for other Government planning "gimmicks" in future tax programs.

I am not suggesting, however, that the legislation would be acceptable in some more normal form of tax relief were substituted for the tax credit. This point seems important to me because I sense that part of the "sell" of the administration's program is to promote discussion of what kind of tax relief, thus tending to obscure the detriments of other parts of the program.

While, by the nature of my company's business, we would get very little out of the investment tax credit, any change to give us the full benefit of the credit, or to substitute other tax relief therefore which would be fair to us, would not chnage our opposition to the legislation as a whole.

Of all of the provisions of the bill, those dealing with taxation of foreign business earnings seem to me to be most unwise and to be the opposite of our national interest.

For whatever reason, the intention of these provisions seems to be that of making it more difficult, and economically unattractive, for American companies to participate in or expand foreign business operations.

I suppose there could be no disagreement that, if the objective were the opposite; that is, to make it easier for American businesses to successfully operate abroad which means overcoming foreign competition wherever it is confronted, the provisions of the bill would be quite different from those included in it.

In my opinion, there never has been a time in the history of our Nation when it was more important that American business have the maximum freedom and flexibility to expand and strengthen its foreign operations.

As I have stated, the objectives seems to be one of nationalizing foreign business operations. The case for such nationalization seems to be that it would put American businesses conducting foreign operations on an equal tax basis with purely domestic businesses, that this would improve our international balance situation by increasing the inflow of income from investments and decreasing the outflow of

capital for new investments, and that some way or other this would make us a stronger participant in the international trade and business of the world.

I strongly disagree that nationalization of American foreign business operations would put these operations on an equal tax basis with purely domestic businesses. Domestically, a corporate shareholder in another corporation does not pay tax on the income of the second corporation until and except to the extent that such income is paid out in dividends.

To impose such a burden on American business shareholders in foreign corporations hence would be a gross discrimination against foreign operations.

It seems to be assumed in the administration's case that such a requirement would force full dividend payouts by foreign corporations. One factor which would prevent this is the restriction on foreign exchange imposed by many nations, and the threat of such imposition during subsequent periods cannot be discounted as regards many other nations. Perhaps some history in regard to the Halliburton Co. would be illuminating here.

Halliburton has 11 foreign subsidiaries operating in 13 foreign countries and operates branches in 15 additional foreign countries.

In 1961 we reported taxable income amounting to approximately $32,600,000 and of this amount $3,723,576.01 represented dividend income from foreign subsidiaries. Total net income after foreign income taxes of our 11 subsidiary companies amounted to $3,699,487—or dividends from foreign subsidiaries exceeded earnings by $24,089.

In addition to the $3,723,576.01 foreign subsidiary income, Halliburton also reported net income from foreign branch operations of $1,164,238. Only 4 out of the 11 subsidiaries paid the above dividends to the parent company, because the others with the exception of the 1 in Italy were unable to pay a dividend.

In February 1961, our Italian subsidiary expressed its desire to the Italian Government to pay a dividend. Not until March 1962, was permission granted to make this payment. Under the proposed Revenue Act, however, Halliburton would have been required to report the Italian income during the year 1961 when it was impossible for it to receive the dividend.

It might be noted that if an amendment were inserted to cure the situation as regards foreign exchange restrictions, then a new element of discrimination would be introduced as regards American companies which would not receive the protection of such restrictions.

It is a strange world when the notion of a foreign exchange restriction could be a blessing, but then it is a strange tax bill with which we are dealing.

The notion that making American business corporations pay more tax on foreign source income, or tax on such income before it is or could be received as dividends, would improve the international balance situation, also seems to me to be strange economic thinking.

American corporations engage in business in foreign countries and organize subsidiaries to carry on this business so that dividends can be paid to the parent company.

However, Halliburton and other parent companies in the United States are, in my opinion, in a better position to know when the sub-

sidiary can afford to make a dividend payment than the Secretary of the Treasury. With very few exceptions foreign subsidiaries are organized to engage in foreign business for a long period of time. We are not interested in making a quick profit by forming a subsidiary and then liquidating it tax free or at capital gains rates. We want to stay in business in all foreign countries so long as we can make a reasonable profit.

It is evident that the more profits earned and reinvested abroad, the greater will be the return income flow as compared with outward capital flow. In view of the present favorable balance of income inflow versus capital outflow, and the prospects that this situation will improve as more foreign investments mature and produce the maximum return of profit without requiring new American capital, the administration's thinking must be based on some misconception of the economic results of foreign policy.

It occurs to me that because the American policy of foreign business investment after World War II was advanced in the name of helping other nations, some have assumed that such investment did not serve our own national interests. Any such assumption would be quite wrong. These investments are now a great national asset and it is obvious that we will need more, rather than less, of such assets in the future.

To put this matter more strongly, if the administration does succeed in getting Congress to levy more domestic tax in regard to our foreign business operations, the price to be paid by the country will be impairment, rather than improvement, in the international balance situation over the long run.

I can't do more than pose the riddle of how this kind of approach would make us a stronger participant in the years ahead in the international trade and business of the world.

In regard to entertainment and expense accounts, the bill seems to proceed on the principle that these phases of business are conducted so as to minimize business profits. Of course, quite the opposite is true. I do not know of any well-run American business that does not look very carefully at the outgo for entertainment, traveling, and so forth as against the benefit in present and future income to be derived therefrom.

The proposed new rules, however, would put so much of the burden of proof upon the taxpayer as to frustrate normal business judgment in regard to such expenses, thus throwing out of the window the entire theory of "ordinary and necessary" business expenses which has been one of the solid anchors of our income tax system since its inception.

As an example of intrusion into business decisionmaking, I can tell you of a Halliburton experience.

Some time ago, we acquired a corporation which owned a lodge where customers were entertained. Over a year ago, we decided to close the lodge and offer it for sale. Today, the lodge has not been sold, and it is not being used because we do not believe the upkeep expense is justified. Presumably, under the regulations in the new provisions, we could not even claim a depreciation deduction as an allowable expense on these facilities.

I can say to you with great conviction that there is no substantial problem of enforcement in regard to the great bulk of American business operations in the entertainment and expense account area. Business management wants to keep such expenses within the concept of "ordinary and necessary" because this is the way to make the most money.

Admittedly, we sometimes have difficulties, and make poor decisions, but alteration of fundamental law as regards the "ordinary and necessary" theory would not help us, it would simply add new complexity and uncertainty to the area, especially in regard to any arbitarary rules which would not fit the business circumstances of a particular activity.

By constant propaganda on this subject, business as a whole has been given a "black eye" on this matter which it certainly does not deserve. Enactment of the recommended provisions, or any change in the tax law in this respect, however, would tend to confirm and be used by the propagandists as proving that business as a whole was guilty all along. This is a time when we need more national unity, not disunity. I simply cannot understand how enactments of this kind would serve the national interest.

In regard to abuses in this area which are not the rule but inevitably will exist, there is no question but that the Revenue Service has adequate power to correct them, not always in advance, but to catch the offenders, and thereby create more examples which lead to less abuses thereafter. To do differently would be to permanently impair the image of American business, in order to catch the cheaters who we will always have among us.

In regard to withholding of money by the payor in regard to dividends and interest, the administration discusses the cost to the Government, but seems quite unconcerned about the cost to the taxpayers and the attitudes of savers and investors which would be built up over a period of time.

I refer to money withheld because the proposed withholding does not, and could not, have any approximate relation in regard to an individual taxpayer's liability, or the liability of taxpayers in this area as a whole. It is a scheme to collect money for the Government, but it is in no sense a scheme to make certain that citizens pay the tax due, no more, no less.

In reading the Secretary's statement, I noted that he attributes a very large yield in relation to evasion in this area from withholding, and a much smaller yield from the automatic data processing system when it is fully operating within a few years.

I assume these estimates are made on the basis that automatic data processing will have a much smaller job to do because withholding already had done so much of the job.

The question which occurs to me is how much of a job could be expected of ADP, together with education and stronger enforcement, if withholding is not inaugurated. It seems to me that the Secretary should be requested to provide this committee with an objective appraisal of the potential for closing the evasion gap both by use of ADP when it is in full operation, and before then by a vigorous information and enforcement campaign which will induce delinquents to file returns and pay taxes on past as well as present and future income from these sources.

If a policy of amnesty is needed in order to make such a program work, then in my opinion it should be established, instead of going to a system of withholding which may well encourage many delinquents to simply accept the 20-percent tax and never fully report their income and tax in this area.

Again, we have in this area a matter of harassing and discrimination against honest taxpayers in order to catch the dishonest. If I may be pardoned the expression, it seems highly "un-American."

In preparing this testimony, it has been evident to me that if the objectionable areas were eliminated, there would be very little left in this legislation. Even the parts of the bill which seem headed in the right direction, nevertheless, seem inadequate to me. It would seem to me that these areas should be covered in separate pieces of legislation which fully cope with the problems involved.

I realize that the point of view I express creates a tough problem for the Government. If, as I believe, the kind of approach reflected in this legislation will make no net contribution to our economic progress and the provision of adequate good jobs for our rapidly increasing working force, then obviously some other approach must be considered.

At least, however, to reject H.R. 10650 as a package would clear the air. If this did not lead to a sound approach to creating a tax policy to serve the purposes of economic growth and national strength, then I for one don't believe that we would be any worse off than we are under the present tax system.

The different approach to serve these worthy public purposes necessarily would involve substantial net tax reduction. I do not know how such a reduction would be achieved except along the lines of the Herlong-Baker legislation, which I understand has been introduced in the record of these hearings for purposes of discussion.

I would urge that the committee thoroughly explore and discuss the full case for this legislation, because I believe it is eminently sound and would add immensely to our economic strength, and the well-being of our citizens in the years ahead.

In considering the Herlong-Baker approach, I believe it should be recognized that it cannot be expected that spending groups will individually or collectively tell the Government that they have had enough.

If this job is to be done, it will be done only if the Government says to the spending groups that further payouts to them will endanger the Nation's future, and adversely affect them as much as the general public.

If the same kind of promotion which has been put behind the program now reflected in H.R. 10650 were given to the Herlong-Baker approach, I personally believe that it would be immensely popular politically.

The reform of tax rates and methods contemplated in the Herlong-Baker legislation would serve in the most concrete way all of the "good ends" generally associated with Government spending programs.

In a few years, such legislation would make our Government stronger because it would have enabled our citizens and businesses to be more self-reliant and productive, thus greatly enlarging the economic base from which all taxes must be taken.

Thank you.

The CHAIRMAN. Thank you very much, Mr. McEnroe.

Senator Kerr?

Senator KERR. No questions.

The CHAIRMAN. Senator Bennett?

Senator Anderson?

Senator ANDERSON. I was very much interested in the portion on withholding income. To summarize, you say withholding on interest and dividends was discrimination against honest taxpayers to catch the dishonest. How do you feel about withholding of workers' pay? We now withhold from workers' pay.

Mr. McENROE. I feel about the same way.

Senator ANDERSON. We also withhold from Senators' salaries. Do you think that is in order to catch the dishonest Senators?

Mr. McENROE. I don't care to comment on that, Senator.

Senator ANDERSON. Well, go ahead, speak frankly.

You indicted all the working class of the country and indicted a lot of other people. Why not indict the Senators? They are not immune.

Mr. McENROE. I think that the Senators' salaries, I mean the withholding made on Senators' salaries or officers' salaries of corporations where the tax could not be avoided is simply because they want to include the officers and Senators and Congressmen along with everyone else.

Senator ANDERSON. I am about to sign my income tax return.

I am not going to be bothered by the fact they withhold $3,000 or $4,000 of money. If it is all right to withhold from the workingman, and sometimes it is difficult to withhold from people who have to pay mortgages, is that un-American?

Mr. McENROE. To me it is, Senator.

Senator ANDERSON. You say it is un-American?

Mr. McENROE. To me it is, sir.

Senator ANDERSON. What American principle does it destroy?

Mr. McENROE. I think our whole income tax law is based upon integrity and honesty of the taxpayer.

Senator ANDERSON. You do?

Mr. McENROE. And I don't believe——

Senator ANDERSON. That man who comes in and audits my report doesn't come on that basis.

Mr. McENROE. He is coming to keep you honest, Senator.

Senator ANDERSON. That is right.

Mr. McENROE. What I meant by this was that I do not believe that laws should be passed to catch the dishonest and penalize the honest people.

Senator ANDERSON. If the Treasury admits there are several hundred millions of dollars that are not being remitted, what is wrong with picking that up?

Mr. McENROE. There is nothing wrong with it, Senator. I had in my prepared text a little on the ADP, and it appears from the Secretary's testimony that the ADP would pick up a great portion of the dividends.

Senator ANDERSON. If it is going to start off in Atlanta or some place and take 10 years to where you and I live, why should we have immunity for the next few years.

You say it is un-American. Isn't it un-American for one group to pay it and another group not to on the same basis?

Mr. McEnroe. That is true.

Senator Anderson. What is wrong with withholding on interest and dividends, why do you label it as un-American? I know it is unpleasant but why is it un-American?

Mr. McEnroe. In the first place, you are making a tax collecting agent out of the payors and employers and you do not reimburse them.

Senator Anderson. You don't think we do that in other instances.

Mr. McEnroe. Yes, we do.

Senator Anderson. Do you withhold workmen's compensation money, I mean the tax on social security based upon salaries?

Mr. McEnroe. Yes, sir.

Senator Anderson. Why don't you let the workman pay it out of his salary.

Mr. McEnroe. We are not allowed to do so, Senator.

Senator Anderson. And that you think is un-American?

Mr. McEnroe. The unemployment compensation is paid by the employer and not by the employee.

Senator Anderson. Yes, that is correct. Social security is based on contributions from both and you hold that out, too, don't you?

Mr. McEnroe. The FIC tax, yes, sir.

Senator Anderson. What is un-American about that?

Mr. McEnroe. Well, you are not giving the employee an opportunity to pay his own tax. It appears to me as though it assumes——

Senator Anderson. Is that all?

Mr. McEnroe. You assume he is dishonest and he will not pay his tax.

Senator Anderson. Do you? Could it be a matter of convenience for collection?

Mr. McEnroe. Or collecting the amount ahead of time.

Senator Anderson. On this expense account, you start off by saying in regard to entertainment expense accounts:

> The bill seems to proceed on the principle these phases of business are so conducted as to minimize business profits.

Do you think there has been any change in the way people reach for the check in the last few years because of the ability to deduct it?

Mr. McEnroe. Senator, I think that the bad publicity given to expense accounts has been caused by a few taxpayers. Certainly, that does not apply to companies like Halliburton nor does it apply to any other companies that I am familiar with.

Senator Anderson. Halliburton is all over the oil country. A few years ago, they had a big convention, there was a high priest of the other side. This was in Amarillo but a thousand oil company airplanes landed at the Amarillo airport. Were they there on oil business?

Mr. McEnroe. I don't know, Senator.

Senator Anderson. Well, the Halliburton plane was there.

Mr. McEnroe. Well, we have business in Amarillo, Senator.

Senator Anderson. Yes. You would be surprised how many oil company men had oil business in Amarillo the day they had that convention.

Mr. McEnroe. I don't think you will find Halliburton takes any part in politics.

Senator Anderson. Do you know of any oilmen who have DC-6's as their private planes?

Mr. McEnroe. No, sir.

Senator Anderson. Well, if you did know one would you think that was a justifiable deduction?

Mr. McEnroe. To attend this convention, no, sir.

Senator Anderson. Well, then, you don't hold to this testimony because it can be shown that a man had a DC-6.

Mr. McEnroe. Senator, I think that is an unallowable deduction under the present law.

Senator Anderson. You do?

Mr. McEnroe. Yes, sir.

Senator Anderson. I have got a photograph of Benjamin Franklin in my hip pocket—I guess I won't, I was going to say I will name you the individual to show it was allowable.

Well, I just want to say to you that a great many people have felt the tightening up of the expense account would be a good thing.

The people I thought who would testify about it would be the people who ran the hotels, the restaurants and night clubs and so forth. I didn't think the business executives would be against it.

Mr. McEnroe. Senator, it puts so much burden of proof, this bill would put so much burden of proof, upon the taxpayer to substantiate a business deduction.

Senator Anderson. What is wrong with that? I gave some money to a venture that some church people organized some years ago in the little town where I used to go to school, and I had a terrible time persuading them it was a proper deduction. The income tax people cut it out from me and didn't cut it out from a woman in Minneapolis who had more money than I did. We had quite a struggle, and I finally won it. I got it crossed off. Did it hurt me? It only persuaded me that the Internal Revenue Service was trying to collect some money. I don't mind justifying it.

Mr. McEnroe. Well, Senator, we quite busy trying to make a profit for the business and we don't have—we don't like to have to substantiate every little business expenditure that is made.

Senator Anderson. I don't mind—you don't have any trouble in justifying business expenditures; what you have trouble justifying is a man putting down a justification where it came to putting down a check for $170, that is where the problem comes, isn't it?

Mr. McEnroe. There was an illustration made in the committee's report on this bill of purchasing football tickets.

Senator Anderson. Yes.

Mr. McEnroe. Certainly, I don't think there is anything wrong in purchasing football tickets for a customer who might be a valued customer and might be a more valued customer because of your having purchased a football ticket for him.

Senator Anderson. Did you ever see the business of dividing up sides where one fellow invites you and you invite him?

Mr. McEnroe. I have heard of it.

Senator Anderson. Do you think it is wrong?

Mr. McEnroe. I certainly do.

Senator ANDERSON. If you stop that loophole, what is wrong with it?

Mr. McENROE. Well, you would be—you still would be disallowing necessary business expenses of honest taxpayers in order to catch a dishonest one.

Senator ANDERSON. Do you know of any other way to find out who is honest and who isn't?

Mr. McENROE. It seems to me as though the Revenue Service has the authority right now to disallow those expenses, under the present code.

Senator ANDERSON. Do you suppose they would want new legislation if they had sufficient legislation at the present time?

Mr. McENROE. This would be an additional source of revenue, Senator. It would, in effect, make us pay tax on a football ticket that we purchased for a customer.

Senator ANDERSON. Which you pay tax on what?

Mr. McENROE. On a football ticket which we purchased for a customer whereas now we can deduct it.

Senator ANDERSON. All right. We all have that practice. The firm which I am associated with buys football tickets for customers but we are not going to close our doors if they stop us from buying tickets for customers because other people are doing it.

Mr. McENROE. Our business is somewhat peculiar, Senator, we advertise in trade journals but we are not selling our product or our services to the general public.

Consequently, it is more a personal contact with us in our advertising or promotions, and the best means of advertising and promotion is to take a customer out to lunch and talk about business.

It might be a nightclub but under the terms of H.R. 10650 because we took him to a nightclub it would be an unallowable deduction.

Senator ANDERSON. You will find a few little ventures where I have paid Halliburton a lot of money but they have never taken me to lunch, I don't regret that. I just say that is not necessary. We just went to Halliburton because we thought it was the best service.

Mr. McENROE. Thank you.

Senator ANDERSON. All right.

Senator BENNETT. Mr. Chairman, I passed a minute ago, but since I am the only man on this side may I question this witness for just a minute?

The CHAIRMAN. OK, sir.

Senator BENNETT. Mr. McEnroe, people who have been questioning you have been saying we have got to do justly and fairly because we now withhold taxes on wages, therefore, we must withhold taxes on interest and dividends.

How are we going to proceed with the tremendous income that comes to the self-employed who represent by far the greatest number of people in business numerically, represent all of the professions, if we are going to say because the worker has his part of his wages withheld, shouldn't this bill attempt to find out a way to withhold part of the fees, part of the other income that comes to the self-employed on the grounds that they, too, perhaps are often not honest and we had better get our share first?

Mr. McENROE. I would agree that would be right, Senator.

Senator BENNETT. So can't we say that even if you were to apply the rules of this bill that a corporation which pays dividends, and to a lender who collects interest we would still leave a big segment of American industry upon whose honesty we must depend to pay their bills?

Mr. McENROE. Senator, that is what I said at the very beginning, that the income tax law is based on a presumption that taxpayers are honest.

Senator BENNETT. So isn't it just as fair to say if we can trust the self-employed perhaps we can trust the corporation and the lender?

Mr. McENROE. I would agree with that, Senator.

Senator BENNETT. That is the point I wanted to make.

Senator ANDERSON. I do wish you would put in the record the reason for your statement the income tax law is based on the presumption that people are honest. I find nothing to base that on. Where do you find it?

Mr. McENROE. It imposes a burden upon the individual, Senator, to file a return voluntarily.

Senator ANDERSON. What?

Mr. McENROE. It imposes a burden upon the individual to file his return voluntarily. The tax collector does not go out to his house and collect the money from him. He files a return, pays the tax to the Government voluntarily.

Senator ANDERSON. Suppose he doesn't voluntarily. Do they come and call on him? Does he receive greetings?

Mr. McENROE. Yes, sir; they certainly do if they know who he is.

Senator ANDERSON. I just don't believe it is based on the assumption that the taxpayer is honest. I believe it is based on the assumption that the Government is entitled to certain revenues from the honest as well as dishonest.

Mr. McENROE. Possibly there is a little difference in semantics. But the tax is imposed upon the honest and the dishonest. I didn't mean to convey the impression that I thought the tax was just imposed on the honest.

Senator ANDERSON. I am not trying to pick at you; I am just trying to find out where you get that presumption that this particular law is based on the presumption that the taxpayer is honest.

I don't know where that presumption arises.

Mr. McENROE. Because it is a voluntary act on him to file a return and pay the tax without a tax collector coming out and grabbing him by the arm and taking him down to the Internal Revenue Office and making him, taking him by the bank and making him dig up some money and pay it over to the Government.

Senator ANDERSON. And if he doesn't do it they come and take him by the arm, don't they?

Mr. McENROE. That is right, Senator.

Senator ANDERSON. So it ceases to be voluntarily, doesn't it?

Mr. McENROE. It ceases to be voluntary there; yes.

Senator BENNETT. But isn't it a case where the assessment is based on the report of the taxpayer rather than on a situation where an inspector comes around and looks over the individual's books like the real estate tax assessor looks over his real estate? The assessment is based on the statement of the taxpayer, not on the judgment of the Government functionary.

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Mr. McENROE. That is true, sir.

Senator BENNETT. It is voluntary; and, that being the case, the withholding principle, while it is that to a certain extent, the Government is now saying, "Well, we can be sure that you are going to owe at least 20 percent of an amount, so you have got to take it and give it to us before you really find out whether you owe anything."

Earlier a question was raised about the constitutionality of the tax bill. There is an interesting question as to whether the Government has the right to withhold money from a person who owes no taxes, even though they may have a right to withhold part of a tax from a man who does owe a tax.

The withholding on the wage earner more nearly meets the situation when the Government can assume the taxload, because you know more about the total volume of wages to be paid than you do about the total amount of interest and dividends to be paid.

When you are dealing with a wage earner you are dealing with one employer and one employee, a relationship between two people.

But when you are starting to withhold on dividends and interest, you don't know how many sources this may be collected from.

Mr. McENROE. You have no idea.

Senator BENNETT. And you have no way of knowing in advance the approximate amount the receiver may owe, if anything. I think this is another complication in the picture and when we are talking about withholding on people other than dividend and interest recipients and recipients of wages, what about withholding on capital gains tax?

There is a form of taxation. We might as well withhold on everything.

What about requiring a seller to anticipate the amount of excise tax he must pay and we might as well have him send 20 percent of that in in advance before he actually sells it. If we are going to carry this across the board, it becomes a little bit ridiculous.

Senator ANDERSON. Right there I recognize that a good practicing Mormon wouldn't understand this, but I understand that people who put bottles of whisky on their shelves put the tax certificate on them before they know whether they are going to sell them. They put the tax certificate on cigarettes before they know they are going to sell them.

They don't know whether they are going to be burned up or anybody will buy them but they put it on.

Mr. McENROE. Senator, isn't the tax levied on the manufacturer?

Senator ANDERSON. On whisky?

Senator BENNETT. And cigarettes. There may be a State tax but the cigarette manufacturer has to buy the cigarette stamp and put it on at the time he manufactures the cigarette.

Mr. McENROE. That is my understanding, Senator.

The CHAIRMAN. Senator Douglas.

Senator DOUGLAS. You discuss the taxation of foreign business earnings and in the paragraph you state:

As I have stated, the objective seems to be one of nationalizing foreign business operations.

I always thought nationalization referred to national ownership. In what way does the administration proposal on taxation of foreign earnings have as its objective the nationalization of foreign business operations?

Mr. McENROE. Senator Douglas, as I went on to explain here, it would have made Halliburton in the year 1961 pay a tax on its earnings in Italy, on its subsidiaries' earnings in Italy.

Senator DOUGLAS. How is that nationalization which refers to ownership of your companies? Are you saying the administration is trying to take over the ownership of Halliburton so far as its foreign operations are concerned?

Mr. McENROE. Well, it is telling Halliburton that it must declare a dividend out of the Italian subsidiary and the Italian Government wouldn't let Halliburton's subsidiary pay a dividend.

Senator DOUGLAS. That is a minor point, that is a particular Italian case.

Are you saying that the taxation of foreign earnings of your company constitutes the nationalization of your company?

Mr. McENROE. I think that it does go to nationalization to some degree.

Senator DOUGLAS. You say the objective seems to be one of nationalizing foreign operations.

You seem to make the charge that the objective of these provisions is to take over the ownership of companies overseas. Do you seriously want to maintain that?

Mr. McENROE. Yes, sir; I do, Senator.

Senator DOUGLAS. You do?

Mr. McENROE. The income is still in the foreign country.

Senator DOUGLAS. You mean that the taxation of income is equivalent to the nationalization of property?

Mr. McENROE. Isn't that a taxation of property; money is property.

Senator DOUGLAS. Then the levying of a corporate income tax constitutes nationalization of the corporation?

Mr. McENROE. Before the income comes to this country it occurs to me as though it is, Senator. And in many cases it is impossible to bring the money into this country.

Senator DOUGLAS. In other words, any attempt by the Government to tax income constitutes the nationalization of the capital assets from which the income is derived according to your statement.

Mr. McENROE. It is an attempt to nationalize the income.

Senator DOUGLAS. No, no; you didn't say that. You say nationalizing foreign business operations and as I say nationalization is popularly and, I think, precisely understood as the national ownership of certain means of production which would mean that the stockholders of Halliburton would no longer own Halliburton but the U.S. Government would own Halliburton at least as the foreign operations are concerned.

Do you seriously want to say that because these words are charged with tremendous emotion, you know, and when responsible business—a responsible businessman charges that this foreign tax system has as its objective the nationalization of foreign business operations, this is a terrific charge.

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Mr. McEnroe. Well, Senator, I believe I didn't intend to go as far as you have gone in your interpretation of this. What I meant was that by making a foreign—making a domestic corporation pay a tax on the earnings of its subsidiary in a foreign country, in effect, is nationalizing the business income.

Senator Douglas. Well, it is taking a portion of the income for public purposes, but it certainly is not the nationalization of the property. You would still run your property. You would still elect the members of your board of directors, you would have the right to the residual income and——

Mr. McEnroe. But it is treating the foreign corporation earnings differently than domestic corporation earnings, Senator.

Senator Douglas. Now, that is another question.

But I think you apparently want to stand on this, but it is a very loose use of language and I think the effect of that language is to confuse the public, and to inflame the public.

That is all.

The Chairman. Senator Gore.

Senator Gore. Obviously, Mr. McEnroe, either the interpretation of the language you have used before this committee differs from ours or you have overstated your position in some instances.

I don't wish to engage in a philosophical exchange, but I would like to call to your attention that you make a rather remarkable statement that "capital is the wellspring of human progress and betterment."

I had been laboring under the impression that money was not the root of all that is good, but that moral and ethical values, government, religion, family life were the principal wellsprings of human progress. Indeed, that the world moves more on ideas than on capital. I will not—perhaps you would like to explain just what you mean by that?

Mr. McEnroe. Well, Senator Gore, what I meant was that you know that many countries have great potential insofar as their raw materials are concerned, but it takes capital to develop those raw materials and that is what I had reference to when I referred to the capital as being the wellspring of human progress.

Senator Gore. In your statement and in your reply to Senator Douglas, you seemed to think that the taxation of the earnings of a subsidiary corporation would be an innovation.

Are not domestic subsidiaries, corporate subsidiaries, of U.S. corporations taxed annually?

Mr. McEnroe. Not to the parent corporation, Senator, only when a dividend——

Senator Gore. They are taxed directly, are they not?

Mr. McEnroe. Right; but the income is in the United States and in the case of the foreign corporation the income has never been brought into the United States, and the parent corporation is not taxed on the domestic corporation's earnings; not until the domestic pays the parent a dividend is that income taxed to the parent.

But in this instance the domestic—the foreign subsidiary's income would be immediately taxed to the parent company under this bill.

Senator GORE. I would like to read you what you say:

Domestically a corporate shareholder in another corporation does not pay tax on the income of the second corporation until and except to the extent that such income is paid out in dividends. To impose such a burden on American business shareholders in foreign corporations hence would be a gross discrimination against foreign operations.

Mr. MCENROE. Well, Senator, you will notice I said a corporate shareholder in another corporation does not pay tax on income of the second corporation until and except and to the extent——

Senator GORE. But the domestic subsidiary is taxed directly, then when, later, the subsidiary's earnings are paid out to the parent corporation, a credit is given for the taxes originally paid by the subsidiary.

Mr. MCENROE. Well, Senator, it doesn't work quite that way.

Senator GORE. Intercorporate dividend credit is 85 percent.

Mr. MCENROE. They get a dividend credit but not a tax credit.

Senator GORE. I didn't say a tax credit. I said they got a credit, I believe it is called an intercorporate dividend credit; I believe the rate is 85 percent.

Mr. MCENROE. Eighty-five percent.

Senator GORE. Now, you say your company has 11 subsidiaries?

Mr. MCENROE. Yes, sir.

Senator GORE. Would you mind informing the committee in what countries these subsidiaries are domiciled?

Mr. MCENROE. I think I can, Senator.

We have one in Italy, Germany, Austria, England, Canada, Trinidad, Peru, Venezuela, Argentina, Mexico, and Spain.

Senator GORE. Is that all?

Mr. MCENROE. I think it is. Yes, sir.

Senator GORE. In which country do you have two?

Mr. MCENROE. Two?

Senator GORE. Your statement said you had 13 subsidiaries in 11 countries.

Mr. MCENROE. These 11 subsidiaries operate in 13 different countries.

Senator GORE. I see.

Mr. MCENROE. Then we operate as a branch in 15 foreign countries.

Senator GORE. In what countries do you operate as a branch?

Mr. MCENROE. I am afraid I can't tell you all of them, Senator, but I can tell you some of them. Saudi Arabia, Libya, Kuwait (neutral zone), Yemen, Brazil, Bolivia—I can't recall any more now, Senator.

Senator GORE. Do you have a branch in any country in which you have a subsidiary?

Mr. MCENROE. Yes, sir. We had one in Saudi Arabia.

Senator GORE. You have both branch and——

Mr. MCENROE. I would like to take that statement back, sir.

Senator GORE. Oh, yes.

Mr. MCENROE. Because of a contract that we have with Aramco, it is not possible for our company to operate for any other company in Saudi Arabia other than Aramco so our English subsidiary has a contract with Getty in Saudi Arabia.

Is that the answer to your question, sir?

Senator GORE. Well, I am not sure. I am asking you to give the answer.

Mr. McENROE. I am not sure now that I know what your question was.

Senator GORE. Well, I wanted to know if you have a branch operation in any country in which you also have a subsidiary operation.

Mr. McENROE. Halliburton Co. conducts a branch operation in Saudi Arabia and an English subsidiary corporation also conducts a branch operation in Saudi Arabia. There are times when some of our equipment will move up in Canada and will do a job close to the border that is more convenient for us to do than it would be for our Canadian subsidiary. The same thing is true in Mexico. But it is not a permanent branch. I would not call it a branch operation.

Senator GORE. Are all of these subsidiaries directly owned by Halliburton?

Mr. McENROE. Yes, sir.

Senator GORE. Do you have a base-holding corporation?

Mr. McENROE. No, sir.

Senator GORE. All the subsidiaries?

Mr. McENROE. All of the subsidiaries referred to previously, with exception of the one in Trinidad, are owned 100 percent by Halliburton Co. Halliburton paid for only 50 percent of the stock in the Trinidad Co. and it owns exactly 50 percent of this corporation's stock. A few years ago Halliburton acquired the stock of a U.S. domestic corporation, which at the time of acquisition owned a Western Hemisphere Trade Corp. which operates in Canada, and a Venezuela corporation. The Western Hemisphere Trade Corp. and the Venezuelan corporation owned by the U.S. domestic subsidiary of Halliburton are still in existence and are operating in Canada and Venezuela. These two corporations are not included in the 11 foreign subsidiaries which I previously have mentioned, because Halliburton could not directly receive dividends from these two corporations and they are not directly owned by Halliburton.

Senator GORE. Well, these questions are in no way accusatory.

Mr. McENROE. I understand.

I like to talk about them.

Senator GORE. A goodly number of concerns in the machine and tool industry, an industry somewhat related in nature to the business in which you are engaged, have multination operations. Now, the chairman of the committee, at my request, asked the staff of the Committee on Internal Revenue Taxation to make a study of taxation of foreign income and on July 21, 1961, Mr. Colin Stam and his staff submitted a report that you might like to read.

I would like to read to you from page 14 and page 15, three or four paragraphs. I will not identify this company, I know the identification of the company; indeed, I called this instance to the attention of the staff of the committee and they made a study of it and made this report.

I would like to read to you from this report:

As an example of how one large U.S. corporation diverted income which should have been attributable to itself to its foreign international subsidiary, the following example is significant. Corporation C has annual sales (including the domestic and foreign sales of its subsidiary corporations) of over $200 million, and it has over 10,000 stockholders. The U.S. parent corporation, its U.S. subsidiaries, and a few foreign subsidiary corporations manufacture capital goods, relatively large and high-priced items of equipment and supplies used by the

buyers in their operations and not for resale to consumers. Their foreign customers in many countries are usually corporations, often very large corporations. Ordinarily these foreign customers deal, directly or indirectly, with the producing corporations in the United States (or with the foreign manufacturing subsidiaries), and usually prefer to take title to the goods in the United States or in the foreign country where the items are manufactured.

The parent corporation organized an international subsidiary under the laws of Liechtenstein which, nominally at least, performs the marketing operations throughout the world (except in the United States and Canada) for the parent corporatoin and its U.S. and foreign manufacturing subsidiaries. The Liechtenstein corporation also performs, nominally, various services with respect to the many foreign licensees of the parent—collecting royalties and fees, transmitting technical information and assistance, etc. But since Vaduz, Liechtenstein (a city of about 60,000 population) is not deemed a "respectable" address, there is another subsidiary of the parent company which is organized under the laws of Switzerland and has an office there. This company does not act as a principal, but is merely the agent of the Liechtenstein corporation, providing, for a small fee, an office and the handling of correspondence, records, advertising materials, etc. Liechtenstein does not have an income tax, so that the profits of the Liechtenstein corporation are free from tax until they are transmitted as dividends to the U.S. parent corporation. Switzerland and its cantons impose income taxes on income earned in Switzerland, but since the services performed by the Swiss subsidiary are only those which a few employees perform in a small office, and since the fee paid by the Liechtenstein corporation for those office services is only slightly more than the cost of the services, the taxes paid to Switzerland and its cantons is negligible.

Although it employs few, if any, salesmen, and the sales of the products of the U.S. parent company or its U.S. subsidiaries are either made directly by the U.S. companies or by independent foreign distributors, the Liechstein company receives a commission of 15 percent of the selling price, out of which it pays 5 percent to the independent foreign distributors. For its services (whatever those may be) in dealing with foreign licensees and collecting royalties and fees for the use of the U.S. corporations' patents, formulas, trademarks and knowhow, the Liechtenstein corporation receives 80 percent of the royalties and fees.

It is evident that the profits thus allocated to the Liechtenstein corporation are grossly disproportionate to the real value of what little work that corporation does. In fact, among themselves, officers of the parent corporation have admitted that the Liechtenstein corporation is nothing more than a tax device, and that it has no real substance. They have directed subordinates to so handle correspondence, sales documents, etc., as to make it appear that the Liechtenstein corporation is a functioning commercial organization, even though, in actuality, transactions are handled as if there were no such foreign company.

You might be interested to know, since you have indicated that most of this bill seems to be based upon the notion that taxpayers were dishonest, that a public-spirited person from inside this organization brought to me the memorandums, copies of correspondence, unquestionable evidence that the Liechtenstein subsidiary was a dummy. Yet to it is paid 80 percent of royalties and fees.

I cite this to you not as an indictment of you and your ideas, but to illustrate to you that there is a real problem of tax avoidance, that devices are contrived to avoid the payment of taxes on profits earned.

I will not ask you if you know the identity of this company. You may. I want to say it is not yours, for the record. Would you condone this kind of operation?

Mr. McEnroe. Senator, I would like to make a correction. I believe in one of your statements and that is that my whole testimony is based upon the fact that the revenue bill indicates that taxpayers are dishonest, I don't think I said that. Only in respect to business entertainment expenses, business expenses, entertainment expenses.

Senator Gore. On withholding?

Mr. McEnroe. On withholding.

Senator GORE. I stand corrected and I apologize to you for having, to that degree, misstated your view.

Mr. MCENROE. I believe it is section 482 under the present Code which can take care of the situation which you have just illustrated to me just now.

Senator GORE. Well, you might be interested to know that the information which I have read to you was brought to me, and it was news to the Internal Revenue Service. Liechtenstein has an economic espionage law and they would quickly throw into jail an agent of the U.S. Government seeking to inquire, or make an inquiry, into the income, the economic status of a U.S. subsidiary corporation.

Mr. MCENROE. Senator, is this big enough——

Senator GORE. How could we reach this?

Mr. MCENROE. Is this company large enough to have its stock on the exchange?

Senator GORE. I think so, yes.

Mr. MCENROE. Or is it large enough to have a certified public accountant audit its books?

Senator GORE. I think so.

Mr. MCENROE. The information would be available to the revenue agent and he could make an allocation of income and expense of the various companies under section 482, I believe.

Senator GORE. No, I regret to disagree with you, that is not the case. Did you ever hear of a place called Zug in Switzerland?

Mr. MCENROE. No, sir.

Senator GORE. I made the mistake, in my State, of pronouncing it "Zug", and a big businessman, a friend, called me aside and said, after my public appearance was over, "Now, if you are going to use that, Albert, the correct pronunciation is 'Zoog'."

Isaid, "How do you know?"

He said, "Well, that is where one of my subsidiaries is located." And 52 subsidiaries of U.S. corporations have been organized in Zug, Switzerland, within the last few months.

What economic resource is there to develop in Zug?

Mr. MCENROE. Senator, I am not sure that I am quoting it right—quoting the right section—but under the present code the Commissioner does now have authority to allocate income and expenses between related taxpayers.

Now, he can't create income but he can allocate income and expenses and if there is phenagling between a corporation which is nothing but a dummy corporation in "Zug" or "Zoog" I would think the Commissioner has the authority under the present code to make an allocation of income and expenses.

Senator GORE. I am aware of that section of the code but I am also aware of the inability of the U.S. Government to get its hands on the records and the assets of the subsidiary in Zug or in Liechtenstein or even in Venezuela.

Mr. MCENROE. Senator, isn't the subsidiary's record audited?

Senaor GORE. No. No, they are not.

Mr. MCENROE. Well, isn't there a consolidated balance sheet and profit-and-loss statement prepared?

Senator GORE. Well, now, what might be revealed or concealed in that consolidated statement would fill many books, many books.

I would like to ask you if your subsidiary in Venezuela performs any services or has employees doing any work outside of Venezuela, or for any company outside of Venezuela?

Mr. McEnroe. In Colombia.

Senator Gore. In Colombia.

Mr. McEnroe. Incidentally, Venezuela, Senator, could be classified as what you would call a tax haven country.

Senator Gore. It is so classified.

Mr. McEnroe. We have not taken advantage of that and we have received more dividends from the Venezuela corporation than all the rest of them combined.

Senator Gore. That is to your credit.

Senator Anderson. You have a little more oil in Venezuela than they do in Switzerland also, bear that in mind.

Mr. McEnroe. Of course, the oil business, drilling activity, is somewhat played out in Venezuela and we are not having to replace our assets as fast as we used to, so consequently we are receiving larger dividends from our Venezuela subsidiary now than we were in the past. When the activity builds up again——

Senator Gore. You have just referred to the dividends you received. In your written statement, you gave us your dividends for 1961.

What was your record in 1960? Will you take us back about 10 years?

Mr. McEnroe. I can't do that, Senator, I don't have that information.

Senator Gore. Would you submit it for the record?

Mr. McEnroe. Would I?

Senator Gore. Yes.

(The information requested follows:)

The amount of dividends received from foreign corporations owned by Halliburton during the past 10 years is: 1952, $1 million; 1953, $1 million; 1954, $1 million; 1955, $1,100,000; 1956, $1,300,000; 1957, $1,300,000; 1958, $2,050,606.60; 1959, $2,281,268.90; 1960, $2,364,555.82; 1961, $3,723,576.01; total $17,120,007.33.

Senator Gore. Why do you choose to operate in branch form in so many countries instead of subsidiary form?

Mr. McEnroe. Well, we try to choose the most economical means of operation, Senator. And in some cases it is more economical to operate as a subsidiary. We may have heat put on us to form a subsidiary.

Senator Gore. Wait a minute, you may have some heat?

Mr. McEnroe. We may have some heat put on us to form a subsidiary corporation. It may not make any difference at all to us whether it is a branch operation or a subsidiary operation. We started business in Mexico as a branch, and PEMEX, which is our big customer, insisted that it would not use our services unless we formed a Mexican corporation so we formed a Mexican corporation. We didn't want to get thrown out.

Senator Gore. A little stock to somebody down there?

Mr. McEnroe. No, sir, we own that 100 percent. Halliburton doesn't do business that way, Senator.

Senator Gore. That is good. That is not always the case in Mexico, though, is it?

Mr. McENROE. I know of some other people who did that and who have had to give some stock in corporations.

Senator GORE. Do you collect any royalties and fees from any foreign company not wholly owned by Halliburton?

Mr. McENROE. I don't know of any royalty to speak of that we collect other than what is collected domestically, it isn't even a royalty.

Senator GORE. Any fees?

Mr. McENROE. Would you mind restating your question, Senator?

Senator GORE. Does Halliburton or any of its subsidiaries collect fees, commissions, royalties for any other of its subsidiaries?

Mr. McENROE. For its subsidiaries? No, sir.

Senator GORE. That are not wholly owned by Halliburton?

Mr. McENROE. No.

Senator GORE. None.

Have any of your foreign subsidiaries made loans to Halliburton or to the Halliburton subsidiary?

Mr. McENROE. No, sir. I will take that back, yes, sir. Once that I know of.

Senator GORE. Would you relate that?

Mr. McENROE. Our Venezuela subsidiary loaned some money to a Canadian subsidiary at one time.

Senator GORE. How much?

Mr. McENROE. It is not in existence any more and it was only for a short period of time.

I do not recall the amount but it was a long time ago.

Senator GORE. Was the loan repaid to the Venezuela subsidiary?

Mr. McENROE. Yes, sir.

Senator GORE. The Canadian subsidiary was a subsidiary of Halliburton?

Mr. McENROE. Yes, sir.

Senator GORE. So Halliburton directed its subsidiary in Venezuela to lend the money to its subsidiary in Canada and thereby it did not find it necessary to advance the money itself?

Mr. McENROE. As I recall, Senator, Halliburton was not in position to advance the money itself at that time.

Senator GORE. So it used the funds of its subsidiary in Venezuela?

Mr. McENROE. That is right.

Senator GORE. On which no U.S. tax had been paid?

Mr. McENROE. That is correct.

Senator GORE. I could do a little better if I had such a source of funds.

Mr. McENROE. The money was paid back, Senator, and that is one of the countries that is called one of the depressed countries or, how is it referred to here, it is not economically advanced. The money was repaid.

Senator GORE. Underdeveloped.

Mr. McENROE. The money was repaid, and later on in the year a dividend with that money was paid to the Halliburton company.

Senator GORE. I am not saying you committed any crime, I am just saying you had a subsidiary in Venezuela with surplus money at hand which it had not repatriated to the United States, and you had another subsidiary in Canada, a country with a high tax rate, and Halliburton, though it needed the surplus money of its subsidiary in

Venezuela, but not having repatriated it, was as you say not in position to advance the money to the Canadian subsidiary. So you just proceeded to use the money in perhaps the same manner that you would have used it if it had been repatriated and if you had paid taxes on it. You proceeded to use it, direct its use in a third country, without repatriation and, therefore, without paying U.S. taxes, and when repaid it was again not repatriated, but paid back to a tax-haven country.

Has it been repatriated?

Mr. McENROE. Well, Venezuela has paid us all the dividends it can afford to pay us.

Senator GORE. But it could afford to lend to a subsidiary in Canada?

Mr. McENROE. In the same year this loan was made Venezuela collected the loan back from the Canadian subsidiary and late in the year paid the Halliburton company a dividend.

Senator GORE. Now, let me ask you——

Mr. McENROE. Now, Senator, because of the fact the income was not taxable, that interest income was not taxable, in Venezuela, it in turn meant that a higher tax rate was paid in the United States when we got the money in the form of a dividend.

Senator GORE. You mean you got more money?

Mr. McENROE. And the U.S. Government got more tax.

Senator GORE. I am not complaining at all about the lack of taxation on interest income in Venezuela. Let me ask you if the same purpose could not have been accomplished if your Venezuela corporation, or subsidiary, had made the loan to Halliburton instead of to a Halliburton subsidiary?

Mr. McENROE. Well, it probably could have been accomplished.

Senator GORE. I am not saying you did accomplish it. But what I am suggesting to you is that it is done that way in thousands of cases.

Mr. McENROE. But Senator, if that money is loaned to a subsidiary, or rather is loaned to a parent and there is no intention to repay that money it can be considered a dividend.

Senator GORE. Well, suppose there is an intention to repay it at regular intervals, and then reloan it. What I am trying to bring to your attention is that this network of international corporate and subsidiary corporations lends itself to great tax abuse.

Now, I know nothing about your business except what I have heard this morning. Admittedly, I have been, I hope not unpleasantly, on a fishing expedition in asking some questions.

You appear to be an extremely honorable, ethical businessman and for that I compliment you, but even so you pointed out one instance in which the parent corporation has had complete control and use, and directed the use, of the funds of its subsidiary without repatriation, and, therefore, without payment of U.S. tax upon those funds.

Mr. McENROE. But, Senator, that money did come back to the United States eventually in the form of a dividend the same year it was loaned. What I am trying to portray and give you an impression of is that I don't believe that Halliburton deals any differently than most honorable corporations deal. We are not trying to make a fast dollar. We are in business in these foreign countries, to stay in business in them for a long time. We don't intend to liquidate these cor-

porations at capital gain rates or tax free. We are going to stay in those foreign countries as long as we possibly can, and we are not investing in a foreign country unless we expect to get a return and we are going to get that return in the form of a dividend, as we have, and we have been receiving dividends through the years more than we have been putting out.

Senator GORE. You understand I haven't accused you of anything nor have I any intention of doing so. I merely have shown by your own testimony an example of a tax abuse. You say it was very limited, that it was perhaps for less than 1 year. Therefore, it was not serious; but it opens up the Pandora's box.

You could have done it in greater amount for a longer period, and then you could have had the second subsidiary beneficiary lend it to still another, and then eventually, perhaps, have a dissolution and distribution.

Mr. MCENROE. Well, Senator Gore, I don't believe we would have done that. If it had been for a longer period of time I certainly would have——

Senator GORE. I didn't say you would, I was speaking of possibilities, not the likelihood of action on the part of your company.

These operations are multitudinous and in some instances multifarious. Have you had an opportunity to read this report that the staff of this committee made?

Mr. MCENROE. No, sir.

Senator GORE. Mr. Stam, will you have one of the clerks——

Mr. STAM. I don't think it has been released.

Senator GORE. It hasn't been publicly released?

Mr. STAM. No.

Senator GORE. Mr. Chairman, why shouldn't it be publicly released?

Mr. STAM. It has got some names, it has confidential information.

The CHAIRMAN. What was the date of it?

Senator GORE. July 1961.

The CHAIRMAN. The Chair is informed there is confidential information which was obtained from the Internal Revenue Department. But I would be glad to confer with the Senator about it.

Senator GORE. I am sorry I was inviting you to read something that was not available for you to read.

(The release of the report referred to was clarified in a subsequent discussion appearing on p. 859 of pt. 3.)

Mr. MCENROE. You will have to withdraw the offer.

Senator GORE. But it's quite a revealing document. These abuses are widespread and the Congress is undertaking to eliminate these abuses, the tax avoidance involved in them, as a matter of good public policy. You would agree that we should have fairness and equity as a principle of U.S. tax policy, I am sure.

Mr. MCENROE. That is right.

Senator GORE. Thank you, Mr. Chairman.

Mr. MCENROE. Senator, what I am trying to portray is that by enacting H.R. 10650, it would work an undue hardship upon the corporation that tries to pay its taxes and does pay its taxes honestly.

Senator GORE. I am fully ready to concede it.

Mr. MCENROE. It doesn't seem to me——

Senator GORE. I hope you don't think I have tried to imply otherwise.

Mr. MCENROE. What I object to is the passage of a law aimed at the cheaters which, because of its language, works an undue hardship on the honest taxpayers—especially when means or tools are available in the present code for the Commissioner to deal with the dishonest.

Senator GORE. Well now, we have traffic lights to check those who would speed through an intersection, but even honorable citizens like the chairman of this committee, find the necessity of obeying the traffic lights.

Mr. MCENROE. That is for his own protection, isn't it, Senator? I hope.

Senator GORE. All right, thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. No questions.

The CHAIRMAN. Thank you very much, Mr. McEnroe.

The committee will recess until 2:30.

(Whereupon, at 12:40 p.m., the committee recessed to reconvene at 2:30 p.m., the same day.)

AFTERNOON SESSION

Senator HARTKE (presiding). The committee will please come to order.

The chairman has been detained on the floor of the Senate, and so we will proceed this afternoon.

The first witness will be Mr. Maurice E. Peloubet of the National Small Business Association.

Good afternoon, sir.

STATEMENT OF MAURICE E. PELOUBET IN BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. PELOUBET. I am Maurice E. Peloubet, a certified public accountant of New York. I am here today to represent the National Small Business Association of Washington, D.C. This association represents some 35,000 small business firms throughout the country. I am grateful to the committee for this opportunity to present my views on the investment tax credit, as embodied in H.R. 10560. On other subjects in the bill, the Small Business Association, if it finds it is necessary, will file a statement.

I am glad to be able to say that I agree with Secretary Dillon on two points.

First, if we are going to have a tax incentive, probably the investment credit is the best one we can have.

Second, the 8-percent credit with the 50-percent income limitation is better than the 7 percent with the 25-percent limitation.

The main question before the committee, however—and I might say before the country—is not how good a depreciation system can we afford, but can we afford to limp along with an outmoded, restrictive, and crippling system which is adding year by year to our enormous backlog of obsolete machinery and equipment?

Shall we commit industrial suicide or shall we let industry keep enough of its earnings to maintain its competitive position abroad, to reduce unemployment at home, and to keep our economy strong and dynamic?

The number and variety of the various plans and devices which have been brought forward to stimulate the growth of the economy and to provide incentives for additional investment in productive machinery and equipment should not be allowed to obscure the broad outlines of the problem. First, there is the primary fact that about $100 billion of plant and equipment in this country is admittedly obsolete and should be replaced.

This figure is supported by a detailed survey made by the Department of Economics of the McGraw-Hill Publishing Co. A large round figure of this sort is easier to understand when it is broken down. For example, 59 percent of all transportation equipment and the same percentage of all textile equipment is over 17 years old. Forty-eight percent of all manufacturing capacity is over 17 years old, and only one-third is 10 years old or less.

This compares with the modern and efficient productive capacity of Western Germany, Japan, and other countries. The primary purpose of any incentive to capital investment, or of any sort of depreciation reform, is to do something to reduce this intolerable burden on American industry. The inefficiency and high costs caused by this great mass of aging and obsolete equipment is primarily responsible for our present unfavorable competitive position compared with Europe and Japan.

This burden of aging and obsolete machinery and equipment did not, for a long time, produce any really spectacular results. However, in the last year or two conditions in the textile industry became so bad that it was clear that some sort of action had to be taken. As the McGraw-Hill survey showed, 59 percent of the textile machinery and equipment was overage. The textile industry and the transportation industry both showed 59 percent of overage capacity, being at the bottom of the list, so far as obsolescence was concerned.

The textile industry was losing markets and was losing jobs. Old, high-cost, inefficient machinery, although the labor cost was very high, did not produce or insure jobs, but, rather, lost them. Just which sector of industry will come to an impasse next is hard to estimate, but there are several candidates.

The complete remedy for this condition is not a tax credit which will put something under $2 billion a year in the hands of industry for growth, or a reduction in useful lives by the Treasury, which may do half as much. The gap in depreciation is something in the neighborhood of $6 billion to $8 billion dollars annually on minimum calculations, and even at this rate it will be many years before the productive plant and equipment in this country is modernized and brought up to European and Japanese standards.

When we consider the decline in the value of the dollar, there has been very little real expansion in the productive capacity of the country, which is clearly indicated by the vast amount of obsolete capacity and the fact that this grows rather than diminishes.

The first and most important consideration, therefore, is that industry must have placed at its disposal sufficient funds at least to main-

tain our present investment and productive capacity. If, in addition to this, real growth is desired, then some form of incentive is needed.

Two things should never be lost sight of. First, the need for additional funds in the hands of industry, which are provided for industry on condition that they are spent for productive plant and equipment; and, second, the fact that if these funds are spent for productive plant and equipment, little or no immediate loss of revenue will result, and the revenue will gain even in the short run.

Up until the last few months Treasury estimates of revenue loss were made and published on the traditional assumption that any change in the law or its administration which would affect the amount of tax collected could have but one result; that is, that the total taxes collected will be increased or decreased by the simple gross amount attributable to the change in methods of administration or rates.

It would be unfair to the Treasury officials to assume that, because they made their estimates on this basis, the actual results and implications of a change in tax rates or methods were not understood by them.

One of the most important characteristics of our tax structure is that no provision, rule, or regulation stands by itself, and no change can be made in one part of the tax structure without having widespread and, at times, almost unpredictable effects on the other parts, and on the business and economic situation of the country.

One of the corollaries to the view that a change in the tax structure can have but one simple and immediate effect is that the amount of income generated by the business activity of the country is substantially static and the Government, therefore, can increase its revenue only by taking more of this static income, either by increases in rates, by bringing in income not previously taxed, or by reducing deductions.

While these seem to be the assumptions implicit in traditional Treasury estimates of revenue effects, it is, of course, true that other Government departments act on quite different assumptions and produce statistics which indicate clearly that we have a highly dynamic economy, increasing in some sectors and decreasing in others.

Those Government agencies which compile figures for gross national product and similar statistics are well aware of the nature of our economy, and understand fully that the results of various economic activities cannot be estimated on the basis of one factor alone.

However, Secretary Dillon, and the staff of the Treasury, seem to be reconsidering their positions on possible offsets to the gross losses in revenue brought about by reductions in depreciation.

Secretary Dillon said that the reductions in lives of textile machinery might result in a gross loss of $25 million which he said would be made up by taxes generated by the increased activity and profitability of the industry.

The Treasury estimated that offsets would reduce the gross loss of revenue from the incentive tax credit, some $1,800 million to $655 million. The reduction might even be greater but the important point is that the Treasury have agreed that offsets to gross revenue loss should be taken into account.

That this is true and that the offsets are much greater than the Treasury estimates is the view of several distinguished Members of the U.S. Senate. They have gone on record publicly in hearings before Senate committees and in the Congressional Record to the effect that the net revenue reduction which would be brought about by an increase in depreciation allowances would be little or nothing in the first year of operation and the revenue would actually increase as the effects of liberalized depreciation were further diffused throughout the economy.

On July 24, 1959, the Subcommittee of the Select Committee on Small Business of the U.S. Senate held hearings on the effect of Federal tax depreciation policies on small business.

At these hearings the National Small Businessmen's Association was represented by its president, Frank M. Cruger, its counsel, John A. Gosnell, and its legislative director, Herbert Liebenson. Joel Barlow, of the Washington law firm of Covington & Burling, and Maurice E. Peloubet of Pogson, Peloubet & Co. were also witnesses, as well as representatives of various manufacturing organizations and associations.

The committee reached this conclusion on the question of revenue loss, in which all members of the committee, except Senator Prouty, concurred:

Your committee has summarized the testimony of some of the witnesses that inflation and current depreciation methods result in the payment of income taxes on $6 billion of capital consumption. Perhaps this will lead some readers to assume that the adoption of depreciation methods to eliminate this capital consumption would result in a revenue loss of $2 billion to $3 billion. Your committee is firmly convinced that any such assumption would be grossly in error.

The testimony and supporting illustrations by Mr. Peloubet were most persuasive on the point that liberalized depreciation allowances would generate enough new taxable earnings among producers of capital goods to offset the tax loss from lower profits resulting from increased depreciation allowances. Witnesses contended that any revenue loss from a fair liberalization of depreciation allowances would not be substantial. It is doubtful that there would be any revenue loss in the second year after such liberalization, and perhaps none in the first. In the third or fourth year, and in subsequent years, revenues should be larger. The economic growth and resulting greater tax base under new depreciation policies should assure the Federal Government of a long-term gain in revenue.

The testimony on which the committee relied in coming to this conclusion was, as follows:

JOEL BARLOW. It is very difficult to prove what might have been. But, in any event, unless we change our (depreciation) policy, the result will be a continuing vicious circle of higher costs, lower profits, less replacement, and, by no means incidentally, a continual drying up of revenues for the Government. One of the reasons our tax structure is inadequate to balance a cold war budget is the shackles it puts on facility expansion and modernization.

Senator BIBLE. Your feeling is that, in order to stay competitive, they will keep liberalizing it [depreciation]?

JOEL BARLOW. Certainly. They have found out that it works. They found out that they get more revenue for the Government because profits of companies are higher because modern facilities make costs lower and their markets larger. The taxable income in the West German state is remarkable. Even with almost a hundred percent writeoff in some categories of productive facilities their fiscal picture is excellent. They are taking much of our South American markets for capital goods industry because of their low-cost production. Not only are their labor rates lower, but only about 10 percent of their industrial plants are over 10 years old, as compared to 65 percent of ours.

MAURICE E. PELOUBET. How much revenue is it going to take away if we have reform?

Well, now, we have devoted quite a little study to this. I don't think our studies are quite completed, but I think they have gone far enough to be able to say that proper depreciation reform will not reduce the revenue at all, because if you have a method of depreciation reform whereby it is required to spend the additional depreciation on new equipment, the amount of tax generated by the expenditure of the money will equal, or perhaps more than equal, the amount of tax lost by the additional allowance, and then we think that, if you buy a machine, you aren't just buying a piece of steel; you are buying labor, you are buying materials, you are buying a profit. Every one of those things generates a tax.

I think, as a minimum immediate tax generation, for every $100 spent on machinery, there is at least $26 of tax generated. Therefore, if, by the allowance of an additional $100 depreciation you can require people to purchase, say, $200 of machinery, there is no tax loss whatever. You have taken it out of that pocket and put it into this one. So that, I think, really depreciation reform is one of the few self-liquidating tax reforms.

I believe most of the people who are interested in depreciation reform would not advocate it if they thought it was going to have a seriously unbalancing budget effect, because if every allowance you made was a dead loss, why, of course, you couldn't advocate something that would cost $4 billion to $6 billion a year. That would be just silly; no matter how meritorious it is, it is impossible. That isn't true. There would be no revenue loss.

Senator WAYNE MORSE. I think it is important that we make clear that this is not a tax dodge, we make clear this is not a scheme on the part of industry to pass a greater tax burden onto the shoulders of the nonbusiness community. But, I am sure it can be demonstrated—as I sat here following you two men this morning, I thought, out of my own knowledge and experience as a lawyer, of the types of proof which can be advanced—to show that it will mean, in the long run, less taxes for the masses, and how important that is when you are trying to sell a legislative reform. And we ought to be able to demonstrate that truthfully and by way of proof.

Secondly, I think you have another case to make in this argument which is going to be helpful in getting legislative reform that you need, and that is the effect of this kind of tax program, with the resulting expansion of the economy and new tax dollars it would create which otherwise would never come into existence, as a check on inflation.

ROBERT LEESON (president, Universal Winding Co.). Senator Morse brought up this question—whether it could be shown this would not affect or hurt the normal taxpayer, and I think bringing out the point that there is no ultimate loss in taxes hits directly at that point.

Therefore, it would seem the only possible legitimate reason for not allowing a shorter period of depreciation is the fear of loss of revenue in the immediate year or years after the change.

But, if it could be shown that a shorter period of depreciation stimulated business, thus creating more earnings and more employment and, thus, at least in the long run, more taxes collected by the Government, then one would wish to measure this advantage against the disadvantage of a temporary lowering of the rate of tax collection.

On January 23, 1961, Senator Smathers introduced a bill which gave, in effect, taxpayers a free choice of depreciation rates, subject to a few not very onerous restrictions.

In his remarks introducing his bill he quoted with approval an editorial from the Washington Star of January 14, 1961:

It is generally argued, however, that capital investment would be stimulated by liberalization in some degree and that the end effect would be expanded employment and higher net tax revenues. The subject is one that the incoming administration and the new Congress should consider carefully.

On January 31, 1961, Senator Hartke introduced a companion bill to that of Representative Keogh providing for reinvestment depreciation. In the course of his remarks he said:

At several hearings before Senate and House Committees, Congress has been assured by nationally recognized experts that our present depreciation system is stifling economic development, slowing down the growth of national income and reducing employment. Furthermore, these same experts have produced evidence, so far unchallenged, that there will be little or no immediate loss of revenue if depreciation is increased and substantial gains in the not very long run.

If these statements are true, and in the opinion of several distinguished Members of the Senate they are, then no consideration of revenue loss or budgetary effect should interfere with effective depreciation reform.

Secretary Dillon has stated that the tax credit plus the reductions in useful lives to be made by the Treasury Department will be adequate to put the American manufacturer on a competitive basis with Western Europe and Japan so far as depreciation and capital allowances are concerned. While these two measures combined will make a substantial improvement in the position, and while they are both valuable and necessary, they are nevertheless far from being sufficient to solve the problem. They will not put enough funds in the hands of taxpayers, and they will not provide the ease of administration and certainty of impact which is required by a proper system of incentive and allowances for the exhaustion of capital.

We must believe that the Treasury Department will do its utmost to bring about as great reductions in useful lives as can be justified under statutory limitation, but the conditions under which the Treasury must work will make it impossible for the Department to give any real assurance to taxpayers that determinations, once made, will not be disturbed or will be carried out consistently.

The administration's proposal to provide depreciation reform, is limited to reducing the suggested useful lives as covered by Bulletin F. The work on the textile industry has been substantially completed, and the Treasury is examining the situation in six other major industries: aircraft, automobiles, electrical machinery and equipment, machine tools, railroads, and steel.

It is clear from the language of Revenue Proceeding 62–1, IRB, January 2, 1962, that the Treasury realizes fully the narrow limits within which it can work in the shortening of useful lives and the contingent and temporary nature of any such reduction.

The Treasury states:

No departure is intended from the rule expressed in section 1.167(a)–1 of the Income Tax Regulations, that the useful life of an asset for depreciation purposes is the period over which it may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. The revised suggested average useful lives reflect the obsolescence which this study has recognized. Such lives may be used by any taxpayer who shows the firm intention to follow replacement practices which justify his use of these lives. However, under section 1.167(a)–1(b) of the regulations, the estimated useful life of property is subject to modification after lapse of a reasonable period of time by reason of conditions known to exist at the end of the taxable year of modification, such as where it is found that the taxpayer's experience, including his replacement practice, does not justify the useful lives used by the taxpayer. For purposes of applying the preceding sentence, Revenue Ruling 90 and 91, C.B. 1953–1, pages 43 and 44, respectively, remain in full force and effect. In any case where a taxpayer can support the use of lives shorter than those shown in the schedule in section 3, use of the shorter lives will, of course, be permitted.

Useful lives determined under such provisions give the taxpayer no assurance that the determination of one year may not be upset or at least disputed in the following year. Opportunities and occasions for dispute and litigation are multiplied rather than decreased.

This is not said in criticism of the Treasury or the Internal Revenue Service. Both are to be commended for their frankness in acknowledging and illustrating the limitations under which they must work.

It is doubtful whether any reforms in the Internal Revenue Service treatment of depreciation can be carried out until the burden of proof has been removed from the taxpayer and agents are persuaded that the announced policies of liberalization and fairness in the administration of the depreciation deduction are, in fact, the basic policies of the Treasury and Internal Revenue Service and are to be properly and fairly enforced, regardless of the immediate effect on the tax collected.

As the Treasury statement points out, these limitations are imposed either by the statute or by regulations which have the force of law. The only way to remove these limitations is by legislation.

Certain lgeislation is already embodied in bills introduced and referred to the Committee on Ways and Means and the Senate Finance Committee. One of these is the Hartke-Keogh bill, which provides for reinvesment depreciation. Legislation providing for capital allowances on the Canadian method rather than depreciation strictly dependent on useful or economic life has been widely advocated as well as an additional allowance in the first year on new property at some substantial rate, say, 20 percent.

Any one of these methods of depreciation reform would be helpful. Reinvestment depreciation is the only method of those proposed which directly reflects the effects of inflation in causing a deficiency in depreciation. It allows, as depreciation at the time of replacement of a facility, the amount that inflation has increased the original construction cost of the facility being replaced. An advantage of this method is to encourage the reduction of the backlog of $100 billion worth of obsolete plant and machinery which is weighing down the American economy and would be particularly valuable to industries in depressed areas and to the established industry using a large proportion of long-lived property.

The Canadian bracket system and rates are based on a concept of flexible capital allowances without the necessity of proving useful life. The taxpayer can annually choose the percentage of remaining asset value he deems appropriate up to stated maximums which vary with the type of facility in use. The current maximums are generally more liberal than rates derived from the useful-life concept in this country.

Some approximation to the Canadian system of capital allowances rather than depreciation based on useful or economic life would eliminate disputes and litigation on depreciation matters, and would give the taxpayer some certainty, now so conspicuously lacking, in the determination of his depreciation deduction. In appendix I an adaptation of the Canadian method to U.S. conditions is shown.

An additional first-year allowance lacks the flexibility for the taxpayer which is inherent in the Canadian system and it would not be

as beneficial proportionately to the depressed industry or to one in which the plant and equipment was predominantly long lived.

The tax credit and the reductions in useful lives by the Treasury Department are the reforms proposed by the administration. As far as they go, they are beneficial, but they are incomplete and insufficient. The tax-credit plan is admittedly an incentive and not a type of depreciation reform—and this, of course, has been stated repeatedly by Secretary Dillon, Under Secretary Fowler, and many other Treasury spokesmen—and if an incentive to growth is needed, it may well be a desirable method of achieving that end. However, the tax credit is not depreciation and has nothing to do with it.

In general, the tax credit is a workable and effective incentive method. There is, however, one modification which is necessary to eliminate a discrimination between industries which can, so to speak, buy their capital goods "off the shelf" and those where the projects for capital expenditure are not completed for a long time but where the machinery and equipment must be paid for as it is being built.

In these industries the tax credit should be allowed when the expenditure is made rather than when the completed project is eligible for depreciation.

That is an important point. I have examples in here that show that the taxpayer might be kept out of his credit from 3 to 5 years by this feature.

Four industries may be taken as examples: Steel, nonferrous metal manufacturing, paper manufacturing, and the manufacture of printing presses. This should be a fairly representative cross section of industry. The steel industry accounts for a large part of the total volume of production and affects almost every other industry. In that industry composite figures for four major steel plants recently visited by representatives of the Internal Revenue Service showed that the full benefit of the tax credit would not be realized until 1966, and the loss of the tax credit, because of the lag of the first 4 years, would never be made up.

The attached appendix II shows the pattern of when these expenditures were made and when depreciation was first taken on them. From this sample pattern an example has been developed assuming level expenditures of $100 a year and indicating amounts eligible for the proposed tax credit of the credit is to be allowed when depreciation is first taken. In the first year only $65 of the $100 expended is eligible for the tax credit; the full $100 is not eligible until the fifth year. If expenditures continue, the amounts not eligible in the first 4 years will never be made up.

The expenditures on which the pattern or model is based amounted to almost $200 million.

In the nonferrous metal manufacturing industry, on a large and representative facility, a tube mill, which did not enter the depreciation base until 1959, payments were made as follows: 1957, $8,975,000; 1958, $9,850,000; 1959, $18,825,000.

In the paper industry it generally took upward of 2 years to build and install a complete papermaking machine.

Statements from three of the largest printing-press manufacturers in the country show that upward of 2 years may elapse between the first downpayment and order for a press and its complete installation, and that 85 percent of the cost is paid before installation.

I believe that for other equipment of comparable size and price, the conditions in the printing-press industry are fairly representative. The qualification of property on the basis of expenditures, as and when made, will do a great deal to increase the immediate effectiveness of the tax credit, and will remove the discrimination which would otherwise exist between industries in which the equipment is bought in small standard units, and installed without great delay, as compared with industries where 1, 2, or 3 years elapses between the first payments and design and engineering work, and the final installation.

No effective depreciation reform is possible without legislation. Effective depreciation reform should, first, in some manner recognize inflation; and, second, the period over which property may be written off should have no necessary relation to any assumed or calculated physical or economic life. The most practical and effective means of recognizing inflation and, at the same time, avoiding the accumulation of large amounts of unspent funds, which would probably be the result of overall replacement depreciation, is the method known as reinvestment depreciation. This method is the only one proposed which would give benefits to industries using large amounts of long-lived property, and is the method which would be most helpful to taxpayers and industries in depressed areas. These are situations which the tax credit would not help, and is not designed to help.

Reinvestment depreciation is essentially the recognition of the effect of inflation on the allowance for depreciation after everything has happened and after the depreciable property has been sold, scrapped, or otherwise disposed of.

Thus it deals with completed transactions and accomplished facts. There are no elements of estimate or anticipation involved.

When depreciable property is sold or retired, an index number representing the change in the value of the dollar is applied to the original cost of the property. The allowance for reinvestment depreciation cannot be greater than the difference between the cost and the current value, as determined by applying the index.

But there is another requirement which must be met before the additional allowance is granted: an amount equal to the current value of the property must be spent, or reinvested, in depreciable property.

If no reinvestment is made, no additional allowance is granted. If only a part of the current value is reinvested, the allowance is reduced proportionately, and if the rest of the amount representing the current value is not spent within a specified carryover period, the possible allowance is lost to the taxpayer.

The amount of the additional allowance is deducted from the total cost of the new property and the remainder is depreciated over the life of the property. For example, a machine costing $1,000 has a current value of $1,500, which amount is reinvested. The reinvestment allowance is $500, and $1,000 is depreciated over, say, 10 years, the life of the property.

There is, therefore, no recovery in excess of cost or, to put it another way, there is a constant lag in current value depreciation represented by the current value of the property in use at any one time.

Reinvestment depreciation would be positive in operation and simple to administer. All the taxpayer needs to know is the cost of his property and when it was acquired. The Treasury would probably

compute the index number, but any of the indexes in current use would be satisfactory; for example, Department of Commerce construction cost, Engineering News Record, or American Appraisal Co.

Reinvestment depreciation, although allowed in arrears, is available as and when needed for reinvestment in machinery and equipment to take the place, in some way, of that retired.

While accounting can and should be adapted to the reinvestment concept, it is essentially a financial method for providing funds for replacement and maintenance as and when needed.

There are no loopholes or opportunities for abuse in reinvestment depreciation. The two limits are always there: the property must be retired; the money must be reinvested.

Reinvestment depreciaton, for that reason, would be the most effective incentive to capital investment and the modernization and maintenance of machinery and equipment.

It would not create cash windfalls and could not be used as a tax-free liquidating device, which might happen under any method which did not require that the money be spent before the allowance would be made.

The requirement is for the reinvestment to be made in depreciable property. It may be any kind or type so long as it falls into the classification of depreciable property.

The present requirement of the statute and the Internal Revenue Code is that depreciation shall be written off over the expected useful life of the property. The difficulties in that are indicated in the extract from Revenue Bulletin No. 1 of the year 1962, given above, which is a significant document because it is, in effect, a statement by the Internal Revenue Service that they have no intention of changing their principles or methods, and that they cannot change them.

The reason for the innumerable annoying and fruitless adjustments made by revenue agents in depreciation calculations is that the determination of a physical or economic useful life is a matter of estimate and opinion, and the revenue agent has a number of ways by which he can force his opinion on a taxpayer. Practically all depreciation adjustments involve merely the transfer of income from one year to another, but as the determination of depreciation is a matter of opinion, the agent can generally find something to change or adjust.

If, however, legislation such as that which has been in effect in Canada for some 14 years were to be enacted here, there would be no reason for any of these adjustments. The Canadian system is based on the principle that the writeoffs of depreciable property do not represent a cost allocated over a useful life, as is required under our laws, but the writeoffs represent what is called a capital allowance.

The capital allowance is determined by classifying in broad groups different types of plant and equipment, and specifying minimum lives for property falling within each group. The taxpayer can take a longer life if he wishes to. He can refrain from taking depreciation in any 1 year. He cannot take more than his original cost, and he must pay tax at ordinary rates on any recovery he makes by selling property at more than its written-down value up to its original cost. For instance, most manufacturing machinery would fall into class 8, where the maximum rate is 20 percent for the first year on a declining balance method.

The only thing the revenue agent can question is whether the property is properly classified. If the property is practically all written off in, say, 7 years, and is in operation for 15 years, and is then scrapped, the agent has no reason to make any adjustment and no authority to do so.

At first sight this perhaps looks like a rigid and arbitrary method, but practical experience for many years in Canada has shown that it is satisfactory, both to the revenue authorities and business. If such a system were in effect in this country, a large number of revenue agents could be relieved from work connected with depreciation and employed on more useful and productive work.

Even though the amount of tax which is brought in each year by depreciation adjustments might be substantial, it really amounts to practically nothing. The collection of tax brought about by the adjustment shows as additional tax, but the subsequent reduction in income does not show in this way as there is merely an additional deduction in the returns for subsequent years, and there is no refund shown to offset the additional tax collected by the adjustment.

If a method embodying the principles of the Canadian system were to be adopted, there would be no additional tax collected, and there would be no additional deductions in subsequent years. Under the Canadian method any recovery of cost on disposal of property is taxed as ordinary income. There would, therefore, be no question of salvage value, and the revenue could not lose on this account.

The method of handling depreciation required under our Government statutes presents a superficial appearance of care and precision, but this appearance is merely the result of extending to a large number of decimal places estimates which are difficult to make and impossible to prove. This committee already has before it an amendment to H.R. 10650, sponsored by Senator Hartke, an amendment which provides for reinvestment depreciation. This amendment is the same as a bill, S. 720, introduced by Senator Hartke and a companion bill introduced in the House by Representative Keogh.

With this legislative the United States would have a reasonable and effective depreciation system which would place its manufacturers and businessmen on a fair competitive footing, so far as machinery and equipment is concerned, they would be on a par with any country in the world, and while this legislation would not immediately wipe out our crushing weight of obsolete plant and equipment, it would at least make it possible to start reducing it. Thank you.

(The attachments referred to are as follows:)

APPENDIX I

CLASSES OF PROPERTY AND RATES OF DEPRECIATION—THE CANADIAN SYSTEM ADAPTED TO U.S. CONDITIONS

The adaptation of the Canadian capital allowance system in the United States would have two principal purposes; first, to simplify the administration of the depreciation deduction by the Internal Revenue Service and, second to make certain and effective for all taxpayers the increases in depreciation which should result from the reexamination of depreciation rates and practices carried out by the Internal Revenue Service for a group of selected industries.

This introduces a new concept into our system of taxation which supersedes another concept or principle which has been embodied in the various revenue acts since the passage of the 16th amendment.

The accounting concept of depreciation, that it was a method of spreading the cost of long-lived property over its useful life, was written into the statutes on the general theory that what was a good method for determining a taxpayer's income for business purposes was a good method for tax purposes.

In general this is true but under the stress and strain of day-to-day dealings between taxpayers and the Internal Revenue Service it has been found desirable to substitute, in situations where there is room for wide differences of opinion on both theoretical and factual questions, a definite, conventional standard, designed to be generally fair and equitable, but not open to change or adjustment by the taxpayer or the Internal Revenue Service.

In place of the present concept of depreciation as an allocation of cost to periods of time it is proposed to substitute minimum lives over which the taxpayer can amortize his capital expenditures rather than to require a more or less precise estimate of just how much value is lost or how much wear and tear has taken place in any particular period.

Depreciation calculations must, of necessity, be estimates and they must take so many and such divergent elements and factors into consideration that, in almost every case, there is room for wide differences of opinion and little or no opportunity for proof of any position or assumption.

Physical wear and tear and technological obsolescence are only two of the elements. Product changes, changes in public taste, population movements, Government policies; in fact almost any important change in social or economic life may require a reassessment of a depreciation charge determined for operating or financial purposes.

It is hardly necessary to enlarge on the expense and inconvenience, both to the taxpayers and the Government, of the innumerable and protracted disputes on highly speculative and theoretical depreciation questions between taxpayers and the Internal Revenue Services.

Furthermore, the usual result of such disputes is merely a shifting of income from one period to another.

Another consequence of the present depreciation methods is the different treatment of taxpayers with similar problems merely because they happen to be in different districts.

No criticism of the Internal Revenue Service is intended or implied. The Service has been given a virtually impossible task to perform but has made valiant efforts to carry out statutory provisions, resolving doubts in what is conceived to be the interest of the Government.

Under present statutes little else can be done. The purpose of the use of the Canadian system would be to substitute reasonable and definite standards of recovery of capital for another general principle; allocation of cost to useful life, which requires the constant exercise of judgment and the use of estimates, produces little or no result in net tax collected, and is the cause of a vast number of disputes and a great deal of litigation.

If these disputes could be avoided a great deal of time now spent by revenue agents in these sterile discussions could be devoted to more useful and fruitful work.

It might appear, at first sight, that the present effort of the Treasury Department to reduce imputed useful lives and to reduce the number of classifications in Bulletin "F," the Treasury guide to useful lives, would have much the same result as the adoption of the Canadian system.

This, however, is impossible as the Treasury Department itself made clear in Internal Revenue Bulletin No. 1 for the year 1962 which said that no departure was contemplated from the rule that expected useful life must govern the depreciation allowance and that adjustments would have to be made if "it is found that the taxpayer's experience, including his replacement practice, does not justify the useful lives used by the taxpayer."

It is thus made clear that the Treasury and the Internal Revenue Service will follow, as they must, statutes now in effect. The taxpayer will have no certainty that any shortened useful life will be adhered to and management decisions on the retirement of property will continue to be made under the influence of tax considerations.

The possibilities of dispute and litigation will not be reduced and may be increased.

The principal value of the Treasury's work in this field will be in the establishment of the fact that present useful lives are too long. Under the Canadian system it will be possible to apply these reduced lives in a positive and easily administered way.

Below are given the groups and the maximum rates and minimum lives for various classes of property.

Class 1 (4 percent)

For purposes of paragraph (1) the percentage rate applicable, to property falling in class 1 shall be 4 percent. Class 1 includes the property enumerated hereunder, and all other property of a similar nature if not specifically enumerated in some other class in this paragraph:

Bridges.
Canals.
Culverts.
Dams.
Jetties.
Roads, sidewalks, parking lots, airplane runways, storage areas.
Railway tract and roadbed not part of a railway system.
Drainage systems.

Class 2 (6 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 2 shall be 6 percent. Class 2 includes the property enumerated hereunder, and all other property of a similar nature if not specifically enumerated in some other class in this paragraph:

Electrical generating equipment except as included in class 6.
Trunk pipelines for oil, gas, or water.
Steam railroad and street railway rolling stock and right-of-way except as included in class 1.
Operating and distributing equipment and plant, including structures of a producer or distributor of electrical energy, gas, water, or heat, except as included in class 4.

Class 3 (5 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 3 shall be 5 percent. Class 3 includes the property enumerated hereunder, and all other property of a similar nature if not specifically enumerated in some other class in this paragraph:

Buildings or other structures of a permanent nature, not included in class 4.
Breakwaters, except wooden.
Docks.
Trestles.
Windmills.
Wharfs.

Class 4 (10 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 4 shall be 10 percent. Class 4 includes the property enumerated hereunder, and all other property of a similar nature if not specifically enumerated in some other class in this paragraph:

Buildings of frame, log, stucco on frame, galvanized iron, corrugated iron: including electric wiring, plumbing, sprinkler systems, air-conditioning equipment, heating equipment, lighting fixtures and equipment, elevators and escalators.
Wooden breakwaters.
Fences.
Greenhouses.
Oil or water storage tanks.
Railway tank cars.
Wooden wharfs.
Airplane hangars.

Class 5 (20 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 5 shall be 20 percent. Class 5 includes all tangible property which is not included in any other class in this paragraph and for which a depreciation deduction is allowable under subsection (a).

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Class 6 (25 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 6 shall be 25 percent. Class 6 includes the property enumerated hereunder, and all other property of a similar nature if not specifically enumerated in some other class in this paragraph:

Electrical generating equipment, if

(i) the taxpayer is not a person whose business is the production for the use of or distribution to others of electrical energy.

(ii) the equipment is auxiliary to the taxpayer's main power supply, and

(iii) the equipment is not used regularly as a source of supply.

Radar equipment
Radio transmission equipment
Radio receiving equipment
Electrical generating equipment that has a maximum load capacity of not more than 15 kilowatts

Class 7 (30 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 7 shall be 30 percent. Class 7 includes the property enumerated hereunder, and all other property of similar nature if not specifically enumerated in some other class in this paragraph:

Automotive equipment, except trolley buses and locomotives
Harness and stable equipment
Sleighs, trailers, and wagons
A building acquired for the purpose of gaining or producing income from a mine (except an office building that is not situated on the mine property, or a refinery)
Contractor's movable equipment, including portable camp buildings
A floor of a roller skating rink
Gas or oil well equipment (including structure) that is normally used above ground
Mining machinery and equipment acquired for the purpose of gaining or producing income from a mine
Property acquired for the purpose of cutting and removing merchantable timber
Mechanical equipment acquired for logging operations
Access roads and trails for the protection of standing timber against fire, insects, and disease
Property acquired for a motion picture drive-in theater

Class 8 (100 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 8 shall be 100 percent. Class 8 includes the property enumerated hereunder:

A book that is part of a lending library
Chinaware, cutlery, or other tableware
A kitchen utensile costing less than $100
A die, jig, pattern, mold, or last
A medical or dental instrument costing less than $100
Linen
A tool costing less than $100
A uniform

Class 9 (40 percent)

For purposes of paragraph (1) the percentage rate applicable to property falling in class 9 shall be 40 percent. Class 9 includes the property enumerated hereunder: Aircraft, including furniture fittings and equipment.

APPENDIX II.—*Timing pattern for investment tax credit (based on actual projects begun in 1958 at 4 major steel plants recently visited by IRS in the useful life study)*

	Percent of total expenditures on projects begun in 1st year, by years				
	1st	2d	3rd	4th	5th
Expenditures made	12	43	40	5	Less than 0.5.
Expenditures on which depreciation is first taken	5	15	68	11	1.

Evaluation of tax credit effect on level investment of $100 per year

	Year of expenditure and transfer to depreciable base																											
	1958		1959		1960		1961		1962				1963				1964				1965				1966			
	X	T	X	T	X	T	X	T	X	P	T	E	X	P	T	E	X	P	T	E	X	P	T	E	X	P	T	E
Year project begun:																												
1958	12	5	43	15	40	68	5	11	*0	0	1																	
1959			12	5	43	15	40	68	*5	0	11	*5	*0	0	1													
1960					12	5	43	15	*40	0	68	*40	*5	0	11	*5	*0	0	1									
1961							12	5	43	0	*15	*15	40	28	*68	*68	*5	0	11	*5	*0	0	1					
1962									12	0	*5	*5	43	7	*15	*15	40	35	*68	*68	5	7	*11	*11	0	1	*1	*1
1963													12	0	*5	*5	43	7	*15	*15	40	35	*68	*68	5	7	*11	*11
1964																	12	0	*5	*5	43	7	*15	*15	40	35	*68	*68
1965																					12	0	*5	*5	43	7	*15	*15
1966																									12	0	*5	*5
Amount of expenditure eligible for tax credit if allowed:																												
When transferred to base												65				93				93				99				100
When expended									100				100				100				100				100			

X indicates amounts expended.
T indicates amounts transferred to base.
P indicates amounts expended after Dec. 31, 1961, and not transferred to base in prior years.
* indicates amounts eligible for tax credit if allowed when transferred to base.

Statement by a nationally known manufacturer of printing presses and printing machinery

Confirming our recent telephone conversation, the normal advance payment requirement on sheet-fed presses and papercutters calls for 25 percent prior to shipment. If shipment can be made within 6 months, the 25 percent is paid upon signing the order; if shipment is beyond 6 months, 10 percent is paid with order and another 15 percent is paid 120 days prior to shipment.

Web-fed presses, both letterpress and offset, are of a more custom nature and have a long delivery and manufacturing cycle. Normally, 10 percent is paid with the order and according to an agreed schedule, progress payments equaling another 70 percent are made prior to shipment. At times, this stretches out as long as 2 years.

Extract from a letter from a nationally known manufacturer of printing presses and similar machinery in response to an inquiry concerning time required to fill orders and payment schedules

Typically there is a leadtime of 12 months or more between the date of order and the date of shipment of the larger web-fed rotary printing presses. The typical terms of sale for printing equipment of this nature call for a downpayment with the order of at least 10 percent and progress payments during the period of manufacture sufficient to bring total payments by the time of shipment up to 85 percent. The final 15 percent is due following a reasonable interval after delivery for installation.

We understand that legislation before Congress would provide for a credit against Federal income taxes equal to 8 percent of capital expenditures. We believe it would be very logical to allow this credit in the year cash was expended by the purchaser rather than in the year depreciation is first allowed on the new equipment in question. The difference could be rather substantial under the payment terms described above, and the incentive feature would be considerably increased by the earlier allowance of the tax credit.

Proposal for two presses from a nationally known manufacturer to a large printing company

The press we are proposing shall comprise:

Two printing units, the plate cylinders of which shall be 57 inches in circumference, equipped with the Hoe magazine underside lockup.

One single-angle bar high-speed magazine folder comprising the folder frames, leading-in rollers, three pair of nipping rollers, one pair cutting cylinders with three knives, a collecting cylinder, a transfer cylinder, against which will operate the rotary perforator, a slowdown trucking cylinder, a jaw cylinder, a slowdown delivery cylinder with three sets of grippers and a creeping belt delivery. The folder shall also be equipped with six chromium-plated angle bars perforated for air.

One rotary perforator.

Two fully automatic three-arm reels, tensions and full speed web-splicing mechanisms.

One motor base plate.

The above described equipment shall be arranged substantially as the press illustrated in the accompanying proposal drawing No. 2118, dated October 29, 1958, and as covered by the detailed specifications appended hereto.

Total price of the above equipment, f.o.b., our plant at New York, N.Y., prepared for intact shipment, is $670,000.

Total price of two presses, f.o.b., our plant at New York, N.Y., prepared for intact shipment, is $1,225,000.

The prices herein are net and based upon a cost estimate computed to reflect factors affecting the cost of manufacture as of January 1, 1958. Should any changes occur in these factors before completion of manufacture, the prices will be subject to adjustment as specifically prescribed in the appended escalator clauses.

Under the present circumstances, the equipment quoted on herein will be scheduled so that shipment of the first press can start from our plant in approximately 11 months, and shipment of the second press in approximately 12 months, from date of receipt of your order, subject to delays due to causes beyond our control.

We suggest the following terms of payment in New York funds:

Five percent of the total purchase price stipulated herein to be paid, in cash, upon your acceptance of this proposal.

Ten percent of the total purchase price stipulated herein to be paid, in cash, at or before the commencement of engineering work.

Seventy percent of the total purchase price stipulated herein to be paid, in cash, in equal successive monthly installments during the period between the commencement of manufacturing and the estimated time of shipment of the machery.

The balance of the total, final-adjusted purchase price to be paid when the equipment is installed and ready for commercial operation.

It is understood that all sales, excise and other taxes relating or pertaining to the sale or delivery of the machinery herein, whether imposed upon the seller or purchaser, or otherwise resulting from the contract herein, shall be added to the purchase price.

Upon your acceptance of this proposal, which is subject to change or withdrawal without notice, and subject to the approval of an officer of this company at New York, N.Y., we will prepare and submit to you the usual form agreement.

Senator HARTKE. Thank you.

You stated if funds are provided for new plant and equipment are actually expended, little or no loss of revenue will result to the Federal Government.

Just how can you justify such a broad statement?

Mr. PELOUBET. Well, the evidence for that is based on Government statistics. It is clear that for every dollar put into the income stream to purchase equipment, about 26 cents is returned as Federal taxes.

Therefore, if any incentive, any additional depreciation which required the expenditure of the additional allowance, if a dollar of that induced an expenditure of $2, there would be no revenue loss, obviously. That is more or less an extreme case.

In general, an allowance of 25 cents—in other words, if there had only been an inflation of 50 percent, instead of 100 percent, the revenue would gain. There is always that offset. That is the principle which has finally been admitted by the Treasury.

Up until a few months ago, the Treasury always said: "We must make our estimates on the traditional basis, which is the gross effect." But they have changed.

I do not think their calculations are right, but at least the principle is right.

That was brought out very fully in the hearings before the Senate Small Business Committee in the summer of 1959, and all of the members of that committee, with the exception of Senator Prouty, concurred in the statement, which says:

Your committee has summarized the testimony of witnesses that inflation and current depreciation resulted in the payment of income taxes on $6 billion of capital consumption. Perhaps this will lead some readers to assume that the adoption of depreciation methods to eliminate this capital consumption would result in a revenue loss of $2 billion to $3 billion. Your committee is firmly convinced that any such assumption would be grossly in error.

* * * liberalized depreciation allowances would generate enough new taxable earnings among producers of capital goods to offset the tax loss from lower profits resulting from increased depreciation allowances. Witnesses contended that any revenue loss from a fair liberalization of depreciation allowances would not be substantial. It is doubtful that there would be any revenue loss in the second year after such liberalization, and perhaps none in the first. In the third or fourth year, and in subsequent years, revenues should be larger. The economic growth and resulting greater tax base under new depreciation policies should assure the Federal Government of a long-term gain in revenue.

Now, that is not the statement of an advocate. That is the report of a Senate Committee, and on that committee were among others, Senator Smathers, Senator Bible, and Senator Wayne Morse, who made a very strong and convincing statement on it. With the exception of Senator Prouty, there was no dissent.

The witnesses were Mr. Joel Barlow, of Covington & Burling, a manufacturer of textile machinery, myself, and several others.

So I think that, right or wrong, that is what some very distinguished Senators believe.

Senator HARTKE. In other words, in substance, what you are saying is that if you want to really put in depreciation reform, if this is the intent and if we are going to eliminate the obsolete plant equipment of the United States and make it competitive with the rest of the modernized countries of the world, that we are going to have to adopt some system which will have safeguards against loopholes for providing additional funds, but, at the same time, provide a method of reinvestment of the capital which is allowed as far as depreciation is concerned in the tax schedule?

Mr. PELOUBET. That is right.

The key to that is that the additional allowance must be required to be spent.

Senator HARTKE. And this will also prohibit the possibility of windfalls, will it not?

Mr. PELOUBET. Yes. There cannot be any windfall because, a windfall would result in unspent available funds. This cannot happen because you have two limits.

One is how much property you are scrapping or discarding, and the other limit is how much you are investing, and both of those limits are applied.

Senator HARTKE. One frequent statement that I hear made concerning this whole matter, even in regard to tax credits, which is, admittedly, not a depreciation reform, but I hear made about all the reformation concerned in the field of doing something to help business to modernize its plants, the statement that in the steel business, for example, 20 percent of which is produced in my home State of Indiana in the United States, that they are at the present time operating, let us say, at roughly 70 percent of capacity; that they factually have a real capacity in excess of 100 percent of capacity; and just recently announced that they were going to cut, probably, or the announcement was made through their trade magazine that they would probably cut their production about 10 percent, which means that they would be producing at about 60 percent of capacity.

The substance of the argument runs like this:

If they have this tremendous capacity, which is not being utilized at the present time, why is there any need to provide any incentive for them to expand or modernize their plants?

Mr. PELOUBET. Well, I think the answer to that is we can all agree that there is excess capacity, but it is an excess of capacity that we do not want; that we do not need; and that should not be used.

It is an excess of capacity which is obsolete either because there are new and better methods and machinery or because the demand for the product has gone off.

There is no excess capacity to produce what is now needed; that is, to produce what is now needed in the most efficient way.

For example, you might have a fine, big plant that would produce railroad rails. Well, now, we are not producing many railroad rails now. We are not selling very many. But you do not have an excess of these new oxygen blast furnaces. They are much more efficient and they can use different types of ore. They are extremely valuable to the industry, and just as soon as it can be done, I imagine that all of the old-style blast furnaces will be replaced.

And there are developments in continuous casting.

There are all sorts of things like that. It is perfectly true that we can make a whole lot of steel, but it will not be the things we want and it will not be done in the most efficient way.

So I think that is the answer to the capacity question.

The same thing is true in the textile industry.

There is an apparent excess of capacity there, but it is hopelessly outmoded, hopelessly inefficient, high cost, and it is ruining the industry.

Senator HARTKE. And, therefore, not competitive with the foreign people?

Mr. PELOUBET. Not competitive.

Senator HARTKE. Who have the modernized plants, is that not right?

Mr. PELOUBET. That is correct.

Senator HARTKE. Can you give us a short example of how reinvestment depreciation would work, an actual example, to a business?

Mr. PELOUBET. Yes. If you had a piece of equipment that cost $100,000, say, oh, 15 years ago, and we will say that the index now—that it was $100,000 15 years ago and it is now $200,000. That wears out and you scrap it.

Now, the current value of that investment is $200,000. If you invest that $200,000, you get the $100,000 that you should have written off if you had known everything that was going to happen between the time you bought it and the time you disposed of it. You did not know that. But at the end you do know, and you get the full allowance at that time.

Now, you cannot write off your future depreciation on the $200,000. You can only do that on $100,000, because your first $100,000 of reinvestment depreciation comes off your base, not like the tax credit that does not come off the base.

But you get the additional funds when you need the money to buy the new equipment.

Now, as you go on, whatever your index is at the end of that time, the same thing happens.

You get your money when you need it, and you get the money on the basis of your original investment brought up to current values by an agreed index number, of which there are several all generally acceptable.

Senator HARTKE. Under this plan, does the new asset take the base of the old asset?

Mr. PELOUBET. Yes, the new asset takes the base. Otherwise, you would get more than 100 percent and we do not contemplate that.

You are always a little behind, but you get the money when you need it; that is the main point.

Senator HARTKE. And can you obtain the deduction without actually spending the money?

Mr. PELOUBET. You must spend the money to get the deduction.

Senator HARTKE. So this is not a gimmick for people who are looking for schemes to make a nest egg for themselves.

Mr. PELOUBET. No; it is not a help to liquidation. As a matter of fact, it is a penalty against liquidation, because you have always got a lag of what the current value depreciation should be on the property you are using.

Senator HARTKE. And this, in effect, however, could provide the means by which business itself could, through the tax structure, modernize our industrial plant in the United States.

Mr. PELOUBET. That is true, and, of course, further than that, the businesses which have the hardest time to modernize, the ones that use the longer term machinery, would be the ones that would get the benefit.

Senator HARTKE. Do you have any estimates of the cost of this measure?

Mr. PELOUBET. Yes; as near as I can tell. I have seen Treasury estimates on this which, I think, are too high.

I made some shots at it last week, and I would say that probably your gross deduction would be somewhere between $4 billion and $6 billion, and your tax would be something between $2 billion, $2.5 billion, or $3 billion.

I think it would be in that area.

Senator HARTKE. But there is also, then, the recoupment that you will obtain as a result of the modernization?

Mr. PELOUBET. Yes.

Senator HARTKE. And the revitalization?

Mr. PELOUBET. Yes.

If we assume that all of the machinery that was scrapped—rather, if we assume that the original cost of everything that was scrapped—was 50 percent of its current value, we would come out even.

That is high because there would be a lot that was less than that.

Senator HARTKE. And also you recoup also by virtue of the fact that you create for the base, for the new asset, the old base?

Mr. PELOUBET. The old base; yes.

Senator HARTKE. And this is also a recoupment as far as taxes are concerned?

Mr. PELOUBET. That is true.

Senator HARTKE. Now, do you have any examples of the inequities caused by the requirement that the tax credit cannot be allowed until the facilities are in operation; that is, under the tax credits proposed by the Treasury Department?

Mr. PELOUBET. Yes; I have several of those.

I took four industries for examples: Steel, nonferrous metal manufacturing, paper manufacturing, and the manufacturer of printing presses, and this gives you a reasonable cross section of industry.

In the steel industry composite figures for four steel plants recently visited by representatives of the Internal Revenue Service in connection with their inquiries into depreciation rates show that—these are actual composite figures, and they show that—in 1962 only 65 percent of the expenditures would be eligible; and then in 1963

and 1964, 93 percent; and in 1965, 99 percent. That would never be made up. That lag would never be covered.

I took one example, as a matter of fact; one of our clients had built a tube mill, a fairly expensive facility. This mill took 3 years to build.

In 1957, they spent $8,975,000.

In 1958, they spent $9,850,000.

In 1960, they spent $18,825,000.

Now, if they had started that in 1962, they would have not got any credit for 3 years.

Senator HARTKE. Although they had expended the funds?

Mr. PELOUBET. Although they had expended just about half of their money.

Now, we have several clients in thte printing business. We also happen to have a few that make presses, and I talked to both groups. At the present time it is the general practice in the printing machinery industry to require a deposit when you order a press and to require progress payments so that by the time the press is delivered you have got about 80 percent paid for. Nobody has a stock of printing presses that cost half a million dollars to a million and a half dollars apiece.

Every press is special to some extent, and from the time the order is given on the simplest one, it would be, oh, 6, 9 months, a year, and on something complicated, like a big four-color press, oh, it might take you 18 months, 2 years, 2½ years, so that it is quite possible, in fact, it is more likely than not, that you would be kept out of 80 percent of your credit on that press for at least 1 year, probably 2.

And the same thing holds with almost any large, complicated machine tool equipment as well as complicated steel equipment; blast furnaces, rolling mills, all of those things.

A smelter takes several years to get it in operation, and usually after you think you have got it in operation, you have got about 6 months getting bugs out of it.

Senator HARTKE. Thank you, Mr. Peloubet.

Thank you for your time and for what I consider to be a very worthwhile discussion.

Mr. PELOUBET. Thank you.

We are at the service of the committee.

Senator HARTKE. You certainly have been in the past to numerous committees here in the Congress and I am certain you will be in the future.

Mr. PELOUBET. Thank you.

Senator HARTKE. The next witness is Leonard Spacek, of the Arthur Andersen Co. Glad to have you with us.

STATEMENT OF LEONARD SPACEK, OF ARTHUR ANDERSEN & CO.

Mr. SPACEK. Mr. Chairman, I am managing partner of Arthur Andersen & Co., public accountants. I want to testify on two subjects, the investment credit and the provisions for tax on foreign corporations.

The omission of a forthright statement of the purpose of the investment credit provisions in bill H.R. 10650 will lead to major con-

fusion and improprieties in accounting for and reporting of the effect of the credit on the income earned by corporations. This will mislead the public as to the value of the capital stocks of corporations.

Section 38 of the proposed bill states:

> There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

I am not here to argue for or against the investment credit. My sole purpose is to ask that your committee insert in the introduction of this section a clear statement of the reason for the allowance of the "credit against the tax imposed," so that if the bill becomes a law, the corporations which receive this credit will be required to account for it properly according to the reason for its allowance.

The reason for allowing this credit must be either—

(*a*) To grant a selective reduction of the 52-percent tax rate on corporate income; or

(*b*) To grant a reduction in the cost of the property, the acquisition of which is intended to be stimulated.

If the purpose of the investment credit is to grant selective reductions of the corporate income tax rate that will benefit current corporate earnings, the tax reductions will produce varying effective tax rates among companies, and will result in corresponding variations in the relation of the tax charge to the profits reported by corporations, depending upon the amounts expended for additions to property. Thus, the reported profits of corporations will be increased merely because of the property expenditures made, even though there may be no increase in profitability of the operating activities.

If it is your intention to achieve these effects and results by applying a different corporate tax rate to each company, then the introduction of the bill should be changed to read:

> There shall be allowed, as a credit against the tax imposed by this chapter and as a modification of the corporate tax rate imposed by this chapter. * * *

If this is the objective of the proposed investment credit, it will distort and overstate the current earnings reported by practically every corporation in the country, thereby producing a bonanza for the stock market speculator and manipulator to the detriment of the small public investor who will not realize or know what is happening. This result will follow because the higher earnings that will thus be reported will increase the market values of stocks by amounts of from 15 to 50 times the total amount of the investment credit.

Speculators can anticipate the favorable effect by knowing the estimated amount of expenditures for property, while the small investors who cannot obtain this information and could not interpret its effect if they could obtain it, will be buffeted about by those who do understand it and seek to take advantage of it. The fluctuations in market values will bear no relation to the normal measures of market value, such as current earning power, profitability of products, successful management, etc.; but for almost the first time in history, profits will depend to a considerable extent upon how much a corporation spends for property additions, not upon what it earns subject to a uniform tax rate. The primary effect of including the benefit of the incentive credit in current earnings will be to provide an incentive for stock speculation—a far cry from the incentive for building and modernizing the productive capacity of the Nation.

The attached schedule was prepared to show the effect of the investment credit on earnings if it is accounted for as increased profits, for certain companies picked at random and based on their 1960 property additions and net income. The schedule also shows the probable increase in market value of the companies' stock that would result from the increased earnings. If the aggregate investment credit for all corporations is, say, $1.2 billion, and this amount is included in profits, the market value of corporate stocks would increase about 20 to 30 times such fictitious earnings, or from $24 billion to $36 billion of inflation in stock market values.

As can be seen in the last column on the right of the attached schedule, accounting for this reduction in investment cost as though it were increased profit will in many instances produce almost immediate inflation in stock market values substantially in excess of the total construction cost. Thus incorrect accounting for this investment credit will produce stock market inflation which will in many cases be greater than the cost of construction without selling $1 of goods or services at a profit—a most unhealthful and unsatisfactory result.

The attached schedule indicates with respect to every 25th company listed on the New York Stock Exchange, what its investment credit would be, based upon 1960 income and 1960 constructive expenditures. Data on 42 companies are set forth in the schedule. The first one, Allied Chemical Corp., which had $49,980,446 of capital expenditures in 1960, would receive a proposed investment credit of $3,498,631, or 7-percent increase in net income applicable to common stock. That would cause a probable increase in the market value of approximately $3.79 a share, or increase the aggregate market value of that corporation's stock $75,712,220 or much greater an amount than the construction which produced the investment credit.

The ratio of the credit to net income, you will notice, in column 5, varies with every company.

It goes from nothing to as high as 113 percent of the income that is applicable to common stock.

On the second page of that schedule, you will note that I have drawn totals of the 42 companies showing that they spent in 1960, $1,234,749,327 for construction that would qualify for the investment credit.

The investment credit would amount to $34,574,828, and the increase in market value by valuing that credit at the same rate that earnings are now valued on the market would increase the market value of those companies' common stock $801 million or two-thirds of the amount that they expended for construction.

It will be noticed that it will be more important for the investor to find out how much construction a company is doing than to find out whether its operations are profitable.

There is an alternative to such chaotic consequences that is consistent with and responsive to the incentive and the purpose of the investment credit. This alternative is to properly account for the investment credit on the corporations' books by applying it against the property investment that gave rise to the credit.

To require this proper accounting—application of the credit against the asset—the bill before your body should set forth the reason for the investment credit, and should state clearly that the credit is allowed for the purpose of defraying part of the cost of acquiring the property

on which it is computed. If this were done, section 38 could be introduced with the following language:

(*a*) General rule: To encourage investments in property and thereby to stimulate the modernization and productivity of American industry by reducing the financial cost of new plant and equipment, there shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

With such a statement of purpose in the bill, the investment credit would be properly applied for financial accounting and reporting purposes against the cost of the property to which it applies.

One more reason for stating the purpose of the investment credit is that Congress should observe the same standard of accountability it is asking of taxpayers. A most important problem in computing taxes today is that of the reason and support for credits received and expenditures allowed so that proper accounting for such items can be made. If Congress fails to state the reason for allowing the investment credit, its action may be directly compared with that of a taxpayer who does not support his expenditures with the reasons and evidence as to why they were made—the basis of all correct accounting.

As a further, and probably the most important, reason why the investment credit should be treated as a reduction of the financial cost of property additions rather than as an artificial stimulant of earnings, are the words of the President and author of the bill taken from the report of the Committee on Ways and Means, House of Representatives, accompanying H.R. 10650:

The centerpiece of these proposals is the 8-percent tax credit against tax for gross investment in depreciable machinery and equipment. The credit should be retroactive to January 1, 1962. The tax credit increases the profitability of productive investment *by reducing the net cost of acquiring new equipment.* It will stimulate investment in capacity expansion and modernization, contribute to growth of our productivity and output, and increase the competitiveness of American exports in world markets.

The report of the Committee on Ways and Means also states:

The investment credit will stimulate investment because—as a direct offset against the tax otherwise payable—*it will reduce the cost of acquiring depreciable assets.* [Italic mine.]

You will not decrease the cost of assets or the cost of acquiring new equipment, and at the same time use the same credit to increase the income of the corporation.

That, sir, is my comment with respect to the investment credit.

I want to go to the next subject——

Senator HARTKE. Before you do, sir, on your chart you show, according to this, General Baking Co. would be a matter of wild speculation.

Let me ask you this:

You show 113 percent there, is that not right?

Mr. SPACEK. That is right.

Senator HARTKE. Now, how can this credit increase the income of General Baking Co. by 113 percent of its income and the credit itself cannot exceed $25,000, according to law, plus 25 percent of the tax?

Mr. SPACEK. Your qestion is a very good one. I am glad—picking a group of companies at random produces one like this because I asked the same question.

Here is the way it comes about, and ordinarily you would never expect it.

This $252,000 for General Baking is limited by the 25 percent limitation, but the income available for common stock of $222,827 is after $400,000-and-some-odd in preferred dividends. The company actually does pay enough taxes so that the 25 percent limitation gives them a total tax credit of $252,000 or a chance to double their income available for common stock and double the price of the common stock on the market.

All I am saying is these are the effects of picking 42 companies at random. I do not know what they would be if you picked them all out and found out what each one of them would do——

Senator HARTKE. Let me ask you on this, basically, is not the problem, which, as I understand it, you are pointing out, the fact that, instead of really providing for aid to capital, that what the net result that could occur on the tax credit is an increase in dividend to the stockholders?

Mr. SPACEK. If you take it up as an income item. I say that has nothing to do with income. It is a credit against the plant account or the cost of the property, and that is the way it should be accounted for and that is the way I implored Representative Mills and the Treasury Department to introduce what I have now testified to into the bill so that proper accounting can be assured.

Senator HARTKE. And you hope that you have more success on the Senate side than you had with the Treasury Department and Congressman Mills?

Mr. SPACEK. I never indulge in hopes.

Senator HARTKE. Those are all the questions I have on this. Senator Curtis indicated he wanted to be here when you testified.

Mr. SPACEK. I will be glad to wait.

Senator HARTKE. Will you proceed with the other section, if you will?

Mr. SPACEK. The other section is on the last page of my memorandum which I have filed with the committee and relates to the tax on foreign corporations.

As public accountants we call to your attention that this bill, in effect, places the American business activities in foreign countries in competition with comparable foreign businesses, but under standards of taxation in the United States. Economically, no corporation in this position can maintain its business position in other countries when the tax in those countries is materially different from the United States. The only "equitable" principle of taxation is uniform applicability. This will not be true of any American company operating in a foreign country except where the tax in that foreign country approximates ours, such as England.

It has been said that the power of taxation includes the power to destroy, and from an accounting point of view this tax law must be viewed as intent to destroy American businesses operating in competition with other businesses abroad.

Again, I am a public accountant. I am not interested in persuading this body how it should tax the American public. I am bringing only to you the facts of what you propose. I am not arguing against the enactment of this portion of the proposed law. I want you only to

understand what the result will be. However, I do point out that from an accounting standpoint this tax is one that will economically destroy many foreign businesses owned by companies in the United States. It would not be a law that would raise any substantial amount of revenues. The products of the businesses thus destroyed would not be replaced by production in the United States or by U.S.-owned companies, but by foreign-owned companies.

We will submit a separate statement to the Senate Finance Committee setting forth our views on the foreign taxation aspects of H.R. 10650. We shall submit it not later than April 24 so that it may be included in the hearing for that day when the subject of foreign income is discussed.

I would like to also add that there are alternatives to what Senator Gore put in the record this morning in cross-examining Mr. McEnroe of Halliburton Co.

He indicated that he was trying to repatriate all of the earnings of foreign companies in the United States under the law. But this is not what can economically be done. If this provision, as it now appears, goes through, a good many companies will consider this kind of approach. Their businesses in foreign countries are well established. The businesses are around the world. They are units of operation just as complete as those that exist in the United States and just as independent.

If you try to tax foreign operations in foreign countries as though they were in the United States, all you are doing to those corporations is saying:

"Move your international headquarters from the United States to Paris, to Milan, to London," and then the American corporation distributes that international corporation's stock as dividends in place of cash dividends, and, thus, in a short while the international corporation with its headquarters in another country will be owned by U.S. stockholders, but the entire headquarters of the organization will be in a foreign land.

Now, this is the only alternative, economically, for some of these corporations that are involved.

There are other questions that Senator Gore raised that are very important such as some of these companies that actually try to avoid and evade taxes in the United States by creating foreign corporations.

This is permissible under the present law.

This might be unpatriotic, but, still, every provision under the law that permits them this avenue of escape is justified, if it is a fact that it is permitted under the law.

Yet, the same principles or criteria of, say, the Personal Holding Company Act applied against subsidiaries would catch a great number of the companies that are now avoiding the tax, if that is what Congress wants.

But it would be a great shame to take companies that are operating independently in foreign countries and deny their ownership by corporations in the United States by compelling them to be owned by individuals rather than corporations.

Now, let me just go one step further.

The question might well be raised that if this is done, the executives of the United States would therefore not be able to manage the companies in foreign countries.

This is not true, because they could easily set up an international corporation with its common stock owned by the company in the United States, put in that international corporation a preferred stock owned by the American company, whereby the international company is required to appoint to its board a majority of the directors from the United States, distribute the stock to the American public, no individual stockholder would own 10 percent or more.

The company's headquarters would be out of the country, and, yet, the managements in the United States would have an influence and power because of the patents and licenses and know-how that they possess.

What I am getting at is that this tax on foreign corporations is no answer to the problems that Senator Gore has put forth. I would not sit here and try to propose that I would outline a complete program by which to meet the problems he poses, but I believe that this could be done in a much better shape than the one that is now being proposed.

It is for that reason that I think that this present provision in the bill is one of destroying the influence and the great effect that the United States has had in foreign countries. Now, again, I want to emphasize it is not my job to tell Congress or this Senate what they should do as legislation.

If this is what they want to do, it is their right.

But to assume that they are going to bring those businesses into the United States is a wrong assumption.

It will not create more labor in the United States or more opportunity in the United States.

It will decrease the opportunities in the United States. That is quite factual, because we have 28 offices around the world in an international partnership. One of the biggest jobs that we do is to make reports on the feasibility of operating or setting up operations in other countries, and we actually serve 28 different nations outside of the United States with direct offices.

The feasibility reports of these companies is primarily on an operating basis.

It is not to avoid taxes.

It is to set up an operation by which it will be profitable to conduct an operation and reasonably assure, a return on and the preservation of the capital.

The exception, of course, is always present, and you cannot—in effect, I do not like to use these comparisons, but it does not seem to be a practical approach to burn down the house to catch one rat.

Senator HARTKE. Thank you, sir.

Mr. SPACEK. That is all I have.

(The tables referred to are, as follows:)

Probable approximate effect on net income and market value of stocks of certain corporations picked at random, that would result from the 7- or 8-percent investment tax credit based on 1960 capital expenditures and 1960 net income

Item	Company	Capital expenditures [1]	Calendar or fiscal year net income applicable to common stock	Proposed investment credit (7 percent on capital expenditures except as noted)	Percent investment credit to net income	Closing market price on Feb. 9, 1962	Probable increase in market value of stock if investment credit had been in effect and credited to income for 1960	
							Per share	Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	Allied Chemical Corp	$49,980,446	$51,286,191	$3,498,631	7	$54⅛	$3.79	$75,712,220
2	American Commercial Barge Line Co	9,596,376	3,643,570	606,790	17	23⅞	4.06	6,347,855
3	American Smelting & Refining Co	11,220,310	20,243,729	785,422	4	64⅜	2.58	14,052,233
4	Anderson, Clayton & Co	4,070,464	8,492,877	284,932	3	49⅞	1.50	4,890,221
5	The Atlantic Refining Co	15,712,000	45,246,000	(2)	----	56⅞	----	----
6	Beatrice Foods Co	10,656,451	10,387,228	745,952	7	65¼	4.57	15,117,126
7	Borg-Warner Corp	17,776,564	26,841,264	1,244,359	5	46	2.30	20,750,290
8	California Packing Corp	5,496,026	15,684,506	384,722	2	30⅜	.61	3,148,470
9	The Cleveland Electric Illuminating Co	23,643,614	20,241,439	[3] 709,308	4	64½	2.58	17,573,729
10	Consolidated Edison Co. of New York, Inc	260,317,000	59,935,000	[3] 7,809,510	13	77	10.01	155,332,407
11	Copperweld Steel Co	6,782,798	2,441,781	474,796	19	42	7.98	9,386,970
12	Cutler-Hammer, Inc	1,696,961	4,901,084	118,787	2	74	1.48	2,293,661
13	Dr. Pepper Co	701,488	626,531	49,101	8	19	1.52	1,024,176
14	Eaton Manufacturing Co	9,724,793	10,744,621	680,736	6	36⅜	2.18	10,494,106
15	Florida Power Corp	29,982,348	11,925,845	[3] 899,470	8	43	3.44	31,459,849
16	General Baking Co	6,223,980	222,827	[2] 252,000	113	6⅛	6.92	10,926,715
17	General Precision Equipment Corp	5,724,712	3,912,000	400,730	10	56	5.60	6,325,166
18	Gulf Oil Corp	322,295,858	330,310,825	[3] 3,320,819	1	41¾	.42	43,320,207
19	George W. Helme Co	1,929,213	1,373,515	135,045	10	43½	4.35	2,610,000
20	Hupp Corp	3,152,753	740,583	220,693	30	9	2.70	11,702,162
21	International Shoe Co	6,651,894	8,867,157	465,633	5	27⅞	1.39	4,723,251
22	Kaiser Aluminum & Chemical Corp	11,782,067	18,009,640	824,745	5	34¾	1.74	26,127,722
23	Kroehler Manufacturing Co	845,587	195,056	(2)	----	14¾	----	----
24	Lionel Corp	4,192,660	681,236	[2] 171,507	25	16½	4.13	4,689,842
25	Manning, Maxwell & Moore, Inc	1,046,924	1,640,846	73,285	4	26½	1.06	832,407
26	Minnesota Mining & Manufacturing Co	42,074,459	70,692,374	2,945,212	4	69⅝	2.79	143,879,566
27	Munsingwear, Inc	522,173	1,569,877	36,552	2	27¼	.55	418,152
28	Niagara Mohawk Power Corp	80,702,863	29,012,078	[3] 2,421,086	8	44⅞	3.59	46,599,421
29	The Ohio Oil Co	61,763,875	39,215,389	[2] 93,750	----	44¾	----	----
30	Pan American World Airways, Inc	160,627,000	7,089,000	[2] 535,000	8	24¼	1.94	12,848,265
31	Chas. Pfizer & Co., Inc	6,804,486	26,032,835	476,314	2	51	1.02	16,879,268
32	Polaroid Corp	7,252,513	8,750,187	507,676	6	198¼	11.90	46,074,777
33	Rayonier, Inc	7,693,262	9,504,303	538,528	6	20⅛	1.21	7,069,240
34	Riegel Paper Corp	3,172,774	3,067,661	222,094	7	34½	2.42	4,031,028
35	Schenley Industries, Inc	1,744,917	10,047,893	122,144	1	25½	.26	1,539,085

36	Sheraton Corp. of America	11,371,728	3,203,910	[2] 432,380	13	18⅛	2.36	12,419,724
37	Sterchi Bros. Shares, Inc.	223,771	625,657	15,664	3	18⅛	.54	321,957
38	Sweets Co. of America, Inc.	76,887	773,373	5,382	1	20¾	.21	55,440
39	United Shoe Machinery Corp.	9,492,729	10,185,626	664,491	7	69⅛	4.84	11,451,237
40	Universal Leaf Tobacco Co., Inc.	2,622,842	4,096,384	183,599	4	52½	2.10	2,506,929
41	Whirlpool Corp.	14,753,000	14,956,000	1,032,710	7	32⅝	2.28	14,190,937
42	Zenith Radio Corp.	2,646,761	15,225,819	185,273	1	67⅞	.68	2,025,458
	Total	1,234,749,327		34,574,828				801,153,269

[1] The amounts shown for capital expenditures exclude expenditures for land, buildings, and property located in foreign countries, where the amounts of such expenditures were determinable from published annual reports or from reports filed with the Securities and Exchange Commission. All other capital expenditures were assumed to be eligible for the investment credit. The tax basis of capital expenditures was assumed to be the same as the book basis. No adjustments have been made for prior-year(s) capital expenditures for property placed in service during 1960 or for 1960 capital expenditures for property not placed in service during 1960.

[2] The proposed investment credit shown is the amount limited under the provision of sec. 46(a)(1)(2).

[3] The proposed investment credit for utility companies is limited to 3 percent of capital expenditures.

Senator HARTKE. Rev. William T. Hogan, Fordham University.

Good afternoon, Father. We are delighted to have you with us this afternoon.

STATEMENT OF REV. WILLIAM T. HOGAN, MEMBER OF THE ECONOMICS FACULTY, FORDHAM UNIVERSITY, NEW YORK CITY

Reverend HOGAN. Thank you very much. It is my pleasure to be here.

My name is William T. Hogan of the Society of Jesus and a member of the economics faculty at Fordham University in New York City.

It has been my pleasure to appear several times before the Committee on Ways and Means of the House of Representatives to discuss the depreciation aspect of tax legislation.

And I am pleased to be here before this committee today.

Today I would like to devote my time to that section of the Revenue Act of 1962 which deals with the tax credit for investment in certain depreciable property. As passed by the House of Representatives this section of the bill represents a part of the administration's plan to assist American industry in a much needed program of replacement and modernization of obsolete plant and equipment. The program is urgent, for many large and small companies in virtually every industry have their share of outmoded and obsolete plants and this has had an adverse and limiting effect on productivity, our industries' ability to compete in world markets, and general economic growth.

The difficulty in replacing plant and equipment stems from two sources: First, the lack of adequate funds due to the inflationary trend which has beset the economy since World War II; and, second, the rapid and increasing rate of obsolesence caused by constantly improving technology.

In connection with the matter of obsolesence, I would like to point out here that I refer specifically to economic obsolesence, for a piece of capital equipment may be physically capable of operating, yet because of innovations and developments in technology, it operates at a much higher cost than the new facilities, and, consequently, has been rendered economically obsolete.

True depreciation reform should take both the above factors into account. In fact, there were bills introduced in both the Senate and the House of Representatives which would help solve the dual problem. The bills introduced in the Senate are those of Senator Hartke and Senator Smathers. The first deals with inflation and the second deals with obsolesence by allowing more realistic lives on assets for tax purposes.

The tax credit plan, although not a correction for inflation, seeks to assist in providing funds for companies to invest in capital equipment. The administraton's approach to the second problem, namely, increasing obsolesence, consists of a survey, now in the process of completion, which could lead to a revision of Bulletin F, the document last revised in 1942 which provides guidelines for the length of an asset's life for tax purposes. The investigation in connection with Bulletin F has been underway since December 1961 and covers some 50 companies in 6 large basic industries. Previous to its start some

adjustments had already been made for the life of facilities in the cotton textile industry.

The present study constitutes an attempt to introduce some flexibility into the length of time in which an asset can be depreciated. For some industries this may be a decided boon, but others have already taken full advantage of the flexibility allowed which is stated clearly in the introduction to Bulletin F:

Although Bulletin F is out of date, the tables of useful lives are reprinted so that taxpayers may not be left without any guide. However, taxpayers are cautioned that the useful lives shown are not mandatory, and were originally published solely as a guide to what might be considered reasonably normal periods of useful life.

Taxpayers may determine reasonable periods of useful life for their depreciable property on the basis of their particular operating conditions, experience, and informed judgment as to technological improvements and economic changes. However, the periods of estimated useful life used by taxpayers are subject to review by the Internal Revenue Service—

I think that is a point to be stressed, these useful life periods are subject to review by the Internal Revenue Service, and, continuing the quotation—

taxpayers should be prepared to substantiate the periods so used.

Now, even if the investigation results in a change in the guidelines set down in Bulletin F, the onus will still be placed on the taxpayer to prove that any length of life chosen by him is reasonable. Thus, in most cases an appeal would be required which, in fact, may not be granted.

It would seem that a more certain approach to the problem of obsolescence would be one which would not require individual appeals but rather would have a minimum length of life written into the law. Such is the case with the Canadian bracket system which specifies minimum lives that, once chosen, are not subject to review by the revenue authorities. Further, this system provides for much shorter lives for capital assets than our system allows; for example, in class 8—one of the brackets in the Canadian system—which includes the bulk of manufacturing plant and equipment, the life is 10 years, while the greater part of this type of property in the United States has a 15- to 25-year life for tax purposes.

On the tax credit incentive plan, I would like to say this: The tax credit incentive plan will unquestionably stimulate investment and will provide assistance to industries for modernization as well as growth and expansion. However, it would seem that the amendment to the original bill which reduced the limit on the credit allowable against tax liability in any taxable year from the first $100,000 plus 50 percent of the excess, that was reduced to the first $25,000 plus 25 percent of the excess, will have a negative influence on the effectiveness of this legislation in achieving its objective.

It will reduce materially the amount of tax credit that some firms will receive. A concrete, and I might say, Mr. Chairman, an actual example will serve to illustrate this point.

A company, which is marginal in its industry though by no means small for it employs upward of 10,000 men, has a capital program laid out for the next 3 years in which it expects to spend $16.5 million in 1962; $19 million in 1963, and $11.7 million in 1964. In 1962 with the expenditure of $16.5 million, the company should, according to

the proposed law, be entitled to a 7-percent credit on this amount, or approximately $1.150 million.

However, its estimated earnings for the current year are $2.4 million before taxes. Its tax bill will be about $1.250 million. According to the amendment to the Revenue Act the maximum tax deduction it can take if $25,000, plus 25 percent of the excess, which in this case on a total tax bill of $1.250 million amounts to $330,000, yet 7 percent of its capital expenditures, as stated above, would be $1.150 million.

Thus in place of a 7-percent credit on its capital expenditure, the firm would have little better than 2 percent. The carry forward provision of the bill, which provides for a 5-year carry forward, will not be particularly helpful in this case, for the company expects to spend $19 million in 1963 and should have a tax credit of $1.330 million. If we add to this the carry forward of $820,000, the company then, and this is in 1963, has a possible tax credit of $2.150 million.

However, based on projected earnings for 1963, the total tax payment will be in the neighborhood of $1.7 million, and 25 percent of this plus the first $25,000 amounts to $444,000.

Thus against a possible tax credit of $2.150 million representing that credited for the year 1963 plus the carry forward from 1962, the company will only be able to take, only $444,000, which is again about 2 percent.

Thus it is that a firm with large capital expenditures but a low rate of profit, and there are a number of these in the basic heavy industries, will scarcely benefit by the tax credit plan as amended. If the original 50-percent limitation were restored in place of the current 25 percent, the picture would be materially improved for marginal firms with heavy capital expenditures. They would be able to get double the amount and come closer to realizing the 7-percent credit which the act intends that they should receive. In a number of cases they will not reach 7 percent but their position will be improved.

These companies have low earning rates precisely because they have a high percent of obsolete equipment. They had hoped to benefit from the tax credit of 7 percent, but, in effect, if the present amendment stands they may get as little as 2 or 3 percent. Thus the people whom this law was intended to help will get extremely little aid. It would seem that we have an inequity here if the 50 percent ceiling is not reinstated. However, if it is not restored, perhaps some of the imbalance could be corrected by amending the bill to allow exceptions to the 25 percent limitation so that low profit companies with high capital expenditures could recoup at least a 5-percent tax credit.

Thank you.

Senator HARTKE. Thank you, Father Hogan.

Let me ask you if you have any comment briefly about the so-called reinvestment depreciation plan.

Reverend HOGAN. Yes, I would like to comment on the reinvestment depreciation plan.

I believe that it gets to the heart, at least in part, of our problem of depreciation and capital replacement.

There are two factors involved. One is the erosion of capital due to inflation, and the other is the length of life that we have assigned to assets, and this very often is unrealistic because of improving technology, and this is going to continue to improve because of the amount

of money invested in research and development year by year. We all know this is an increasing amount.

Now, the reinvestment depreciation plan hits at the first problem, namely, the erosion of capital due to inflation.

It will give those who need capital to replace their plant and equipment a better opportunity to do this. Because of the deficit between the replacement cost and that amount which has accrued from depreciation reserves is so great, we should, if we are going to replace the obsolete equipment in this country, do something to make that up.

The reinvestment plan allows us to do that.

Another feature of it which, I think, is particularly attractive and should never be lost sight of, in fact I do not think it can be stressed enough, is that this plan requires reinvestment, that the money be spent, so that not only is the full depreciation spent but the extra amount that is allowed under the plan, that is, the difference between original cost and its present purchasing power, is also spent, and this should create quite a number of jobs in industry.

It will create jobs in the industries that are providing the capital equipment and this ripple effect will also be felt throughout the economy.

Another thing that I am afraid some people do not understand too well about it is that it is not necessary to replace the identical asset. As long as you invest the same amount of money you can veer off into another line of business.

Let me give you an example. The wire business in the steel industry has not been too profitable of late because of foreign competition, and a company that has a facility for drawing wire may want to go into another phase of the steel business.

Well, as long as it puts that money into investment it has the flexibility of going into another phase of the steel business.

So I feel that this is one plan that strikes at the root of our depreciation problem and insures the reinvestment of the money. I would certainly favor it as a plan, but that is not the plan which has been under discussion this afternoon, so I did not mention it in my prepared statement.

Senator HARTKE. I appreciate that, sir.

I have no further questions from you, sir. Thank you, Father, for coming.

This concludes the list of witnesses who were scheduled to be heard this afternoon.

The committee will adjourn until 10 o'clock tomorrow morning.

I want you to know that Senator Byrd, the chairman of the committee, is sorry that he could not be here this afternoon, but this is a pressing time. I have held another committee waiting for 30 minutes where I am supposed to Chair another meeting this afternoon, too, and I will finish that one also. These are busy times, and I just hope that you folks will excuse the occasional inconvenience that occurs during the hearings, which is just absolutely impossible to avoid.

(By direction of the chairman, the following is made a part of the record:)

SIDNEY, MONT., *February 14, 1962.*

Hon. MIKE MANSFIELD,
U.S. Senate, Washington, D.C.

DEAR SIR: As an income tax practitioner I wish to present a proposal which I feel will bring more fair taxation for farmers and businesses.

Present law provides that a depreciation deduction be taken whether or not it provides tax benefit. My proposal is that maximum depreciation limits be provided as under the present law, but that minimum allowable limits be removed to allow decreased chargeoff in bad years.

Dryland farm clients of mine have had poor crops in recent years. Depreciation for these farmers is often not needed but must be deducted anyway under present law. The deduction is wasted and could probably provide tax benefit if deducted in the future when crops improve.

I propose to allow depreciation not deducted in one year to be carried over as a future deduction.

For example, in 1961 farmer A, with a wife and two children had little crop. His net income without depreciation deductions is $4,000. But the depreciation he must take on his equipment under present law is $3,000. So he ends up with $1,000 net taxable income. He needs to deduct only $1,400 of depreciation to pay no tax.

I propose to let him decrease the deduction to $1,400 and allow him to carry over the unused deduction of $1,600 to future years. This would help level out the farmer's taxable income by averaging. He needs every equitable break he can get to stay in business. This equitable averaging would mean that he could use his family exemptions to better advantage.

Such allowance would be equitable to all, and would help both businesses and farmer-ranchers.

I would appreciate your seeing that this proposal reaches the proper committee for review.

Sincerely yours,

H. N. WILLIAMSON.

UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION,
Washington, D.C., March 23, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: On March 9 the board of directors of our association gave consideration to various proposed changes in the tax laws and adopted the recommendations which are embodied in the attached statement. We hope you may find time to consider it.

The independent telephone companies of the country, a vital part of the American economy particularly in the smaller towns and rural areas, comprise more than 3,000 companies, have 12 million telephones, and operate in 10,700 communities. Their trade organization, now in its 65th year, undertakes to speak for independent companies on matters of national interest to them.

Because of the pressure of time likely to face the Senate Finance Committee, we shall not request an opportunity to make a formal appearance at public hearings but will appreciate it if our statement may be carefully reviewed and placed in the printed proceedings.

Thanking you in advance for your consideration, we are,

Sincerely yours,

CLYDE S. BAILEY,
Executive Vice President.
FRANK G. LAPRADE,
President (President, Lee Telephone Co., Martinsville, Va.).

STATEMENT BY UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

The United States Independent Telephone Association is the national trade organization representing the independent branch of the telephone industry, comprised of more than 3,000 companies furnishing telephone service to 10,700 cities, towns, and rural areas through 12 million telephones. At a meeting of

the board of directors of the association on March 9, 1962, the following tax recommendations were formulated with a request that they be communicated to the Senate Finance Committee.

(1) The 10-percent telephone excise tax

At the earliest possible opportunity consistent with the Government's need for revenue the 10-percent tax on telephone service, both local (general) and long distance, should be repealed. It was initially a wartime levy designed to limit telephone usage in order to conserve critical materials. The tax has long outlived its original purpose and as the only remaining tax on an essential household utility should be allowed to die. It is inequitable and discriminatory in the extreme and despite the essential character of telephone service the tax is in the same amount as the levy on luxury items such as liquor, cameras, country club dues, and so forth.

(2) Reduction in corporate income tax

Reduction in the corporate income tax rate by 5 percentage points to 47 percent is also long overdue. The reduction would stimulate the flow of investor capital into legitimate enterprise and create additional employment opportunities in many fields.

(3) Withholding tax on dividends

The imposition of a withholding tax on dividends would add tremendously to the paperwork of corporate enterprise. It would increase the cost of doing business without compensatory advantages so far as the rendition of telephone service is concerned. We oppose such a tax. In addition to creating many economic and other problems for business like ours, a withholding tax would introduce untold hardship in the case of great bodies of small investors who rely to a large extent upon their dividends for current living expenses.

(4) Proposed repeal of dividend credit and $50 exclusion

The proposed repeal of the 4-percent dividend credit and the $50 dividend exclusion for Federal income tax purposes is entirely unrealistic and we hope will be rejected by the Senate committee. Legitimate enterprise is already sorely pressed by double taxation on business carried on in the corporate form. It needs the benefit of the stimulation provided by the existing modest credit and the equally modest $50 exclusion. We are of the opinion that instead of eliminating these salutary provisions of law, the credit and the exclusion should be materially increased in order to minimize the hardship imposed by existing law upon corporate business and in order to stimulate the flow of equity capital into corporate life and thus assist in creating additional employment opportunities.

(5) The proposed investment tax credit

Instead of the proposed investment tax credit, our association is of the opinion that a more desirable and constructive approach would be to liberalize the existing depreciation rules so that telephone companies (and other business) may be permitted to write off depreciation expense on the basis of current value instead of original cost. If a more realistic depreciation base is not deemed feasible, then our association is of the opinion that telephone companies should be entitled to the full proposed 8 percent tax credit, rather than the discriminatory 4 percent contemplated by the tax bill as reported by the House Ways and Means Committee.

(6) Taxation of cooperatives

We are of the opinion that the tax discrimination now enjoyed by cooperatives should be eliminated.

(7) Plugging of loopholes

Our association feels it should not take a position regarding the plugging up of tax loopholes, because we are of the opinion that proper enforcement of existing laws would eliminate any current abuses.

(8) Increase in unemployment compensation tax

Pending before Congress is a proposal to increase to 3.5 percent from 2.7 percent the unemployment compensation tax. This would represent a sizable tax burden to be added to the burdens already borne by American business. It is anyone's guess how long any business can continue to absorb additional tax levies without increasing the cost of its product or service. When the cost of

doing business becomes more than can be borne, the inevitable effect is an increase in prices and a contribution to the spiral of inflation. Inflation is already eating at the vitals of the American economy.

AEROQUIP CORP.,
Jackson, Mich., March 28, 1962.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: I have viewed with consternation the progress of the administration's tax revision bill as proposed by the Committee on Ways and Means of the House of Representatives, identified as H.R. 10650, and usually referred to as "the Revenue Act of 1962." The whole subject of the revisions proposed in this bill seems to be inimical to the best interests of the United States. It is the opinion of most thinking businessmen and citizens of our great country, with whom I have talked, that most provisions of this bill can be categorized as being conceived in haste, compromised with theoretical abstract objectives, and clearly opposed to foreign policy objectives of our country.

The proposed incentive credit for investment in depreciable property is neither justified nor desired by American business. It is another example of unwarranted experimentation by novice academicians and economic theoreticians. The justification for such a credit is not compatible with good business practices and seeks to accomplish by indirect stimuli those objectives which can only be effected by the dictates of prudent business principles.

Section 6 provides authority for the Secretary to impute additional taxable income on intercompany transactions regardless of the business purposes and considerations inherent in established prices. Personally, I resent the unwarranted allegation that American businessmen are unconscionably diverting domestic profits to foreign countries in which they may have affiliates. I am sure that facts will not support the existence of such a business policy as has been attributed by the proponents of this bill. Actually, I believe that proponents of this bill have ventured far into the realms of possibilities. Since existing statutes presently in the law give adequate authority to examining internal revenue agents to control such possibilities, and since significant deficiency assessments rarely result from detailed examination of actual operating conditions by the Internal Revenue Service, there is conclusive proof that no serious abuses exist in this area.

Another unrealistic proposal in this bill is the provision (sec. 13) requiring the recognition of earnings of controlled foreign corporations for purposes of computing income subject to taxation in the United States. This indeed is a very strange departure from reality, since the income may never be available for repatriation. Income of a foreign corporation usually is significantly different from economic income because of accounting customs prevailing in the foreign country. Inconvertibility of the currency is also a significant problem which has been conveniently overlooked.

Section 13 also introduces a strange concept in the establishment and perpetuation of mutual understanding and respect in the field of foreign relations. The image of the "ugly American" will not be improved by this grasping, conniving attempt to usurp profits earned from business operations in foreign countries. Logically, such a tax program should provoke retaliatory legislation from foreign countries, since they will justifiably believe that as long as the tax costs must be paid currently to a government, it should properly belong to them because theirs was the country originating the profits being confiscated.

Section 13 will not, in my opinion, favorably affect the balance of payments and quite probably will have an adverse effect on our own national economy. Domestic corporations will be forced into either (1) a reduction in the established dividend policy, because of paying out funds otherwise available for dividends in the form of anticipatory taxpayments on income that may never become available for repatriation; or (2) forcing domestic companies to borrow the funds necessary for the continuance of their present dividend policies, thereby increasing the demand for borrowed funds. This additional demand may have a corollary effect of increasing interest costs, which is diametrically opposed to the announced objectives of this administration.

Section 21 of the proposed bill has the effect of abrogating treaties negotiated in good faith with other sovereign nations. This also is a historic precedent-setting concept of maintaining international goodwill. Foreign nationals have been amazed and incredulous that such a provision could be seriously entertained

by a country trying to impress other nations with the necessity of honor and integrity in the field of international relations. The sacredness of our word and formally executed agreements will be degraded if this proposed legislation passes.

H.R. 10650 seems to me to epitomize the superficiality of callow theoreticians advocating spurious and illusory economic concepts and just simply is not compatible with the honor and dignity of the United States. The method of presentation of this bill seems to me to be a positive denunciation of the capabilities of our Federal legislators. The power politics of the administration are quite frightening, and the seemingly apparent effectiveness of the administration's intimidation of Congress makes thinking citizens of our country fearful of the consequences that we will all have to face if Congress abdicates its responsibilities to academically orientated theoreticians, many of whom are not of sufficient maturity to qualify for elective office.

Wisdom is the judicious blending of intelligence, facts, and knowledge. I suggest to you, Senator, that wisdom is not represented in the group who have drafted and are advocating passage of this bill, and who are attempting to stampede the Congress of the United States into careless legislation by clamor and force to seize more authority for the executive branch of the Government.

I urge you to use your best influence and persuasiveness to defeat these strange and unproven theories represented in H.R. 10650.

Sincerely,

F. M. DAVISON, *Assistant Treasurer.*

CHAMPION SPARK PLUG CO.,
Toledo, Ohio, March 29, 1962.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: I am opposed to H.R. 10650 because this bill represents more than a tax bill, it represents a drastic change in the role of the Federal Government in the management of American business.

Specifically, section 2 of the bill provides an 8 percent credit for investment in depreciable property. This type of legislation is a tax "gimmick" that is no substitute for a fundamental reform of depreciation. The tax credit for investment invites the Federal Government into management's decision-making on plant expansion.

Section 4 disallows certain entertainment, etc., expenses. This section repeals the "ordinary and necessary" business expense concept and substitutes statutory judgment for the judgment of management. Therefore, to the extent that a business would feel it necessary to incur expenses beyond those permissible under this legislative straitjacket, it would be forced to pay taxes on the amount involved as though the amount were income. In economic effect, this would be a confiscation of income. The law, as it now stands, provides the Treasury Department with all the authority it needs to eliminate any abuses in this area.

Section 14 provides that gains from certain dispositions of depreciable personal property would be taxed as ordinary income rather than as capital gains. Such a change should only be made as part of a fundamental reform of depreciation, involving substantial reduction in required lives of depreciable assets.

Sections 5, 6, 7, 11, 13, 15, 16, and 18 provide broad changes in the taxation of income earned by a foreign subsidiary. These changes would mean that, in general, the income earned by a foreign subsidiary of a U.S. company would be subject to U.S. taxation, unless the income is reinvested in the subsidiary, itself, or in another company subsidiary in a so-called less developed nation.

This type of legislation is in direct opposition to President Kennedy's Alliance for Progress program directed toward assisting our Latin American neighbors. In Brazil, for example, it would tax U.S. companies on earnings which cannot be repatriated to the United States and which dwindle with each day of Brazilian inflation.

In addition, as a result of the "gross-up" provision in the new bill, dividends that are received would be taxed on an amount greater than that actually received.

Section 3 of the bill entitled appearances, etc., with respect to legislation, while a step in the right direction, is only a modified version of the Boggs bill

(H.R. 640) which is the type of corrective legislation that is needed in this area.

From the above it can be seen that not only is H.R. 10650 incompatible with economic growth, but far more serious it is not tax reform but rather a big step away from the American tradition of free enterprise.

The type of tax reform that is really needed is contained in the Herlong-Baker bill that was tabled by the House Ways and Means Committee on February 19, 1962.

If the United States is to remain economically strong and free, this bill must not pass. I implore you to examine its many provisions thoroughly, because I know that you will recognize that it is not sound tax legislation but an attempt to further control the American economy.

Very truly yours,

R. W. VOGEL, *Assistant Treasurer.*

(Whereupon, at 4 p.m., the committee recessed, to reconvene at 10 a.m., Friday, April 6, 1962.)