REVENUE ACT OF 1963

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 8363

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO REDUCE INDIVIDUAL AND CORPORATE INCOME TAXES, TO MAKE CERTAIN STRUCTURAL CHANGES WITH RESPECT TO THE INCOME TAX, AND FOR OTHER PURPOSES

DECEMBER 2-6, 9 AND 10, 1963

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REVENUE ACT OF 1963

MONDAY, DECEMBER 2, 1963

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

The committee met, pursuant to recess and subsequent postponement, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd and Douglas.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The Chair places in the record a memorandum of comments on H.R. 8363 by the Association of the Bar of the City of New York, submitted by Mr. D. Nelson Adams, chairman of the committee on taxation, and the other 21 distinguished members.

(The document referred to follows:)

THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

(Members of the committee: D. Nelson Adams, chairman, Robert P. Adelman, M. Bernard Aidinoff, Joseph E. Bachelder III, Renato Beghe, Wayne Chapman, Wallace J. Clarfield, Walter Cliff, Richard R. Dailey, Secretary, Hans J. Frank, Victor H. Frank, Jr., Arthur A. Feder, Wilbur H. Friedman, James A. Glascock, Jr., Arthur Kalish, James A. Levitan, Carter T. Louthan, John H. Perkins, James R. Bowen, David Sachs, David G. Sacks, H. Gilmer Wells)

MEMORANDUM OF COMMENTS ON H.R. 8363, THE REVENUE BILL OF 1963, PREPARED FOR THE USE OF THE COMMITTEE ON FINANCE

Set forth below are the comments of the Committee on Taxation of the Association of the Bar of the City of New York on various sections of the H.R. 8363, the revenue bill of 1963.

GENERAL COMMENTS

This committee has in the past frequently called attention to the ever-increasing complexities of the Internal Revenue Code. Not only is it impossible for a layman to understand even its simplest provisions, but even lawyers and accountants specializing in the field are unable to understand many of the more technical provisions of the code without the aid of lengthy committee reports and explanatory statements which are often in themselves confusing and which may or may not reflect the true intent of Congress.

It is recognized that the problem is to some extent unavoidable. Given the nature of the subject and the policy of providing detailed rules to cover a multitude of exceptions, it is inevitable that the statute will be a highly complicated piece of legislative machinery. If the present trend continues, however, the ultimate result may be a completely unworkable statute, so difficult to understand and apply that taxpayers and their advisers will be forced to proceed without proper legislative guidance.

For this reason it is important that qualifications and exceptions to general rules, and technical provisions of narrow application, be avoided wherever

possible. Some of the provisions of H.R. 8363 have been so narrowed in their application that the initial objective has been largely lost sight of and virtually all that remains is an unduly complicated set of provisions which will accomplish little except further to encumber the statute. Specifically, the committee feels that this is particularly true in the case of section 220, relating to the recapture of depreciation on real property, and in the case of section 223, relating to the surtax exemptions of controlled corporations. In other instances, notably section 204, relating to the taxation of reimbursed medical expenses, section 209(a), relating to the additional 10-percent charitable limitation in the case of organizations receiving a substantial part of their support from the public, section 213, relating to interest on loans to carry insurance and annuity contracts, and section 217, relating to the aggregation of oil and gas well properties, H.R. 8363 has introduced exceptions to existing rules which involve very little revenue but which raise issues which will be difficult to administer.

The amendments to be made to the capital gains tax by section 219 will require thousands of individual taxpayers to understand the difference between three classes of capital gains and losses and the order in which gains and losses in one class are to matched against gains and losses in the other two classes. It is believed that policy decisions are too often made without recognition of the lengthy and highly complicated provisions required to carry out the policy. The objective to be achieved from the policy should be balanced against the increased confusion on the part of taxpayers in attempting to comply with the law and the difficulty of tax administrators in enforcing it.

It is recommended that the overall benefit to be derived from adding the above-mentioned provisions to the code be reexamined in the light of these considerations.

On the whole, the committee believes that given the highly technical nature of the subject, H.R. 8363 has been well drafted. In accordance with its usual practice, the committee has avoided commenting upon matters of pure policy and has limited its comments to technical matters.

TECHNICAL COMMENTS

Section 121

Section 121 of the bill amends section 11 of the code to provide for new rates of taxes on corporate income. The new rates are effective for taxable years beginning after December 31, 1963, with a further reduction to take place for taxable years beginning after December 31, 1963. Corporations using a fiscal year will benefit from these provisions in that tax reductions will become effective for such corporations on December 31, 1963, and December 31, 1964, with respect to income apportioned to portions of fiscal years extending beyond those dates. In this regard a cross reference to section 21 of the code, relating to fiscal year taxpayers, would be helpful.

Section 123

Section 123 of the bill amends section 821 of the code to provide new rates of tax on the income of mutual insurance companies. It also amends section 963 to provide reduced percentages with respect to the minimum distribution of earnings and profits by a controlled foreign corporation which will be required in order to avoid inclusion of the subpart F income of the controlled foreign corporation in the gross income of its shareholders. The reduced minimum distribution percentages presumably reflect the reduction in corporate income tax rates provided by the bill.

Section 951(a)(1)(A) of the code requires a U.S. shareholder of a controlled foreign corporation to include in gross income his pro rata share of the corporation's subpart F income, and section 963 (both now and as amended by the bill) exempts from this rule the subpart F income of a controlled foreign corporation which makes specified minimum percentage distributions of its earnings and profits. These percentages vary inversely with the effective foreign tax rate, as defined in section 963(d). The purpose of this exception is to avoid the impact of subpart F in situations where, as a result of minimum distributions, the overall effective tax rate (including the foreign tax paid by the corporation and the U.S. tax paid by the shareholders on the distribution) reaches a reasonable level. Since, under certain circumstances, subpart F income can include U.S. source in-

come subject to U.S. taxes,[1] it seems to us that as much effect should be given to the U.S. taxes paid on such subpart F income as to foreign taxes paid on other subpart F income.

Section 202

Section 202 of the bill repeals the requirement that the basis of property eligible for the investment credit be reduced by 7 percent of the qualified investment and provides for an upward adjustment in the basis of property placed in service prior to the effective date of the new provision. Section 202 also repeals the requirement, in the case where a lessor has elected to treat the lessee as having acquired the property for purposes of the investment credit, that the lessee reduce its rental deductions over the term of the lease by 7 percent of the qualified investment and provides for an increase in rental deductions over the remaining term of the lease to compensate for previous rental reductions.

With respect to property placed in service after June 30, 1963, the repealing provisions apply to all taxable years ending after that date, but with respect to property placed in service before July 1, 1963, such provisions and the provisions for compensating upward adjustments do not apply until the taxpayer's first taxable year beginning after June 30, 1963.

The aforementioned effective dates have the following consequences:

1. No taxpayer, regardless of the date upon which his taxable year begins, need reduce the basis of property acquired or constructed by him, or the rental of property leased by him, if such property was placed in service after June 30, 1963.

2. A taxpayer who has acquired or constructed property and has placed it in service before July 1, 1963, must reduce the basis by 7 percent of the qualified investment. He may not increase his basis by the 7 percent until the first day of his first taxable year which begins after June 30, 1963; e.g., if he has a fiscal year beginning June 1, he must depreciate the property on the reduced basis until June 1, 1964. Commencing with his first taxable year beginning after June 30, 1963, he may depreciate the amount of the investment credit over the remaining life of the asset.

3. A lessee who has been entitled to the investment credit upon property placed in service before July 1, 1963, must continue to reduce his rental deductions until his first taxable year beginning after June 30, 1963; e.g., if he has a fiscal year beginning June 1, he must reduce his rental deductions until June 1, 1964. Commencing with his first taxable year beginning after June 30, 1963, he may recoup the aggregate rental reductions to that date over the remaining terms of the lease.

Thus, the actual effective date of the principal changes made by section 202, with respect to property placed in service prior to July 1, 1963, may vary by as much as 11 months, depending solely on the fiscal year of the taxpayer. Although minor discrimination might be justified on the ground of the administrative simplicity in making the basis (or rent) adjustment as of the beginning of a taxable year, so great a variation dependent solely on the fortuity of the taxpayer's fiscal year seems excessively inequitable, particularly in a situation in which the deductions accrue continuously over time. In fact, it is quite common for the deductions which will be primarily affected by section 202(a), depreciation and rent, to be calculated on a monthly rather than an annual basis. It is suggested that this unfairness be eliminated by making the adjustment in basis (or rent) with respect to property placed in service before July 1, 1963, effective on July 1, 1963, for all taxpayers.

Section 202(e) expresses the intent of Congress that the investment credit provide an incentive for modernization and growth of private industry which is regulated, as well as private industry which is not regulated. In addition, section 202(e) expresses the intent of Congress that Federal regulatory agencies will not immediately "flow through" to the taxpayer's customers the benefits from the investment credit. Presumably, most or all Federal regulatory agencies will follow this expression of intent. Nevertheless, to make clear that this subsection is not merely precatory but mandatory upon the Federal regulatory agencies, it is suggested that the words "Congress does not intend that any" be eliminated from the second sentence of section 202(e) and that the word "no" be substituted therefor.

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[1] Income derived by a foreign corporation from sources within the United States is excluded from subpart F income only if that corporation is engaged in trade or business in the United States. Code section 952(b). Thus, for example, rentals received by a foreign corporation from a passive investment in U.S. real estate would be subpart F income and, at the same time, subject to U.S. income tax.

The language of the clause following paragraph (2) of section 202(e), which reads "to reduce such taxpayer's Federal income taxes for the purpose of establishing the cost of service of the taxpayer * * *", is a somewhat inaccurate way of defining what the Federal regulatory agencies are not to do. Actually the taxpayer's Federal income taxes will already have been reduced by the investment credit, and it appears to be the purpose of this provision to prevent such reduction in tax from being taken into account by the regulatory agencies in ratemaking. Furthermore, since a common method of determining rates in the case of regulated industries is to determine a fair rate of return upon investment, it would seem advisable to include in the same clause a provision that no Federal regulatory agency should allow a lower rate of return on investments qualifying for the investment credit than on other investments of the taxpayer (Cf. H.R. 7111, 88th Cong., 1st sess.). The clause in question may thus be revised in the following manner: "to take into account the reduction in such taxpayer's Federal income taxes resulting from the investment credit, to allow a lower rate of return on such taxpayer's plant investment with respect to which the investment credit was allowed, or to accomplish a similar result by any other method."

Section 203

Section 203 of the bill alters the present tax treatment of premiums paid on group life insurance by employers. Under the present regulations, group term life insurance furnished to an employee is not considered to be taxable income. Under the bill, as a general rule, the employee's income will include so much of the cost of such insurance furnished by the employer as exceeds the cost of $30,000 of such insurance and the employee's contribution to such cost. To this general rule, however, there are exceptions. The first excludes the cost of group-term insurance provided by an employer after the individual has terminated his employment with such employer and either "has reached the retirement age with respect to such employer" or is disabled. The report of the Ways and Means Committee, states (p. A31) that the determination of retirement age is to be made in the same manner as is applicable under section 105(d) of the code with respect to wage continuation plans.

The term "retirement" as used in section 105(d) is not entirely clear. In Rev. Rul. 57-76, 1957-1 Cum. Bull. 66, as modified by Rev. Rul. 61-6, 1961-1 Cum. Bull. 15, the Commissioner took the position that retirement age meant the lowest age at which an employee could retire without the employer's consent and at the full rate set forth in the plan without reduction because of retirement prior to the age at which retirement is compulsory. However, in *Winter v. Commissioner*, 303 F. (2d) 150 (3d Cir. 1962) the court affirmed a decision of the Tax Court holding that an employee who could have retired at 60 without his benefits being computed at any different rate would not be considered retired for wage continuation purposes until he reached the compulsory retirement age of 65. Rather than to inject the present uncertainty of section 105(d) into the new provision of the bill, it would seem preferable to set forth the desired rule in the statute.

The second exception excludes the cost of group-term life insurance provided by an employer where a charitable beneficiary described in section 170(c) of the code is the sole beneficiary. The statute contains nothing to limit the right of the employee to claim a charitable deduction by reason of such a designation. However, the general explanation of the bill (p. 41) states with respect to the bill: "It is not intended, however, that he receive any deduction for a charitable contribution with respect to such assignment." If Congress desires to place such a limitation upon the right to claim a charitable contribution, the statute should be amended to so provide.

Section 204

Section 204 of the bill amends the code by requiring a taxpayer to include in income, amounts received under accident or health insurance policies in reimbursement of medical expenses, to the extent such reimbursement exceeds the medical expenses incurred. Medical expenses are as defined in section 213 (e) of the code, except that they do not include amounts paid for health or accident insurance.

The additional revenue which will be secured from the amendment hardly seems worth the addition of another section to the code and the complications which will result in the preparation of returns. In any event as now drafted the statute seems unfair.

Accident or health insurance premiums are not deducted in computing the amount to be included in gross income under the bill and may be only partially allowed as medical expense deductions under section 213 because of the various limitations imposed by that section. Such part of an accident or health premium as is disallowed by the percentage limitations of section 213 should be deductible in computing gross income under section 204 of the bill. The medical expenses disallowed as deductions by such percentage limitations should be deemed health and accident insurance premiums to the extent thereof.

Section 207

Section 207 of the bill amends the code to allow as deductible taxes only State, local, and foreign real property taxes; State, local, and foreign income; war profits and excess profits taxes; and State and local personal property and general sales and use taxes. All other taxes which are not specifically disallowed by section 275 of the code will be deductible only to the extent they constitute expenses of carrying on a business or of an activity producing income.

Real property taxes are not defined although personal property taxes are. In order for a personal property tax to qualify it must be an "ad valorem tax which is imposed on an annual basis." The Ohio personal property tax which is imposed on a yield basis rather than a fair market basis may not qualify, although it clearly should be allowed as a deduction. In some jurisdictions taxes are imposed upon property owned on a date specified by the taxing authority. If more or less than 12 months elapse between two such successive taxing days, the tax may be nondeductible because it is not an annual tax. Any definition of real and personal property taxes should include ad valorem taxes as well as any taxes imposed in lieu thereof. Annual should be changed to "periodic" or omitted.

A sales tax is deductible under the bill only if it is imposed at one rate in respect of retail sales of a broad range of classes of items. However, the bill provides against disqualification merely because a lower rate is applied to, or an exemption is granted to, "food, clothing, medical supplies, and motor vehicles." Thus, it is not clear whether a reduction of rate or the allowance of an exemption to any other item will result in disqualifying the tax as a deduction. New York City exempts newspapers and periodicals for policy reasons and exempts cigarettes because they are subjected to a special levy. It seems obvious that the New York City sales tax should not be disqualified. The same problem could arise as to alcohol and gasoline which frequently are subjected to special taxes. The statute should be amended to avoid disqualification under such circumstances.

Report of the Ways and Means Committee indicates that the policy reason for the disallowance of taxes other than those specified is the difficulty or impossibility of maintaining adequate records as to such taxes. Such reason is not valid as applied to real property transfer taxes imposed in New York City, Philadelphia, and Pennsylvania or to mortgage recordation taxes. Such taxes usually are imposed infrequently, but in substantial amounts, so there would be little difficulty in verifying them. The statute should be amended to allow deduction of taxes of this general character.

Section 209

Section 209(a) of the bill would add two types of organizations to those described in section 170(b)(1)(A) of the code, expanding the types of organizations to which the additional 10-percent limitation is applicable: a governmental unit (limited to gifts made for exclusively public purposes) and a charitable organization that "normally receives a substantial part of its support" from either a governmental unit or from the general public or from both.

The vague language of the proposed "substantial support" test would appear to be a source of future problems. What does the word "normally" mean? What period of the organizations' history should be used in making the determination? Moreover, what constitutes "substantial" support? The general and technical explanations in the committee report seem to equate "substantial" with "support from at least a representative number of persons within the community concerned," but the technical explanation also uses a quantitative test in requiring a comparison of the amounts received from the public with the amounts received "from all other sources." (It should be noted that the identical test appears in section 503(b)(3) of the code (relating to exemption of certain organizations from prohibited transactions sanctions) and has never been defined by the Treasury.)

Since it may be expected that a large number of organizations that have been ruled tax exempt will seek a determination that contributions to them would qualify for this additional 10-percent deduction, it is suggested that Congress consider making the "substantial support" test more definite.

Section 211

Section 211 of the bill would amend section 214 of the code to expand the category of those entitled to deduct child care expenses and to increase, in certain cases, the maximum amount which may be deducted from $600 per year to $900 per year.

Subparagraph (5)(B) of subsection 214(d) seems inordinately restrictive. While it is designed to include within the definition of a woman not considered as married one who has been deserted by her spouse, it requires that she not know the whereabouts of her husband at any time during the taxable year and that she apply for a support order to a court of competent jurisdiction. It would seem that a woman should be considered as not married if she has applied for a support order whether or not she knows of her husband's whereabouts. Similarly, it would seem that a woman should be considered as not married if she does not know her husband's whereabouts at any time during the taxable year even if she has not applied for a support order which, in such a case, might well be a meaningless act. In short, it is suggested that the conditions to qualification in the case of a woman deserted by her spouse be made disjunctive rather than conjunctive.

Section 212

Section 212 of the bill would add a new section 217 to the code to provide a new deduction for moving expenses paid or incurred in connection with the commencement of work by a taxpayer as an employee at a new principal place of work. The allowance of a deduction for such expenses is designed to correct the difference in tax treatment under present law of moving expenses reimbursed to employees moving to another place of business of their present employer and those paid to employees accepting employment from a new employer. Under the present position of the Internal Revenue Service, no deduction is allowed an employee for expenses incurred in moving to a new job location whether to work for the same or a new employer, but a person already employed is entitled to exclude from his income allowances or reimbursements for moving expenses received from his present employer if the change of job location is made for the convenience of such employer. (Rev. Rul. 54-429, 1954-2 Cum. Bull. 53.) Furthermore, a recent decision by the Tax Court of the United States holds, with several dissents, that a person already employed is entitled to deduct moving expenses to the extent they exceed the employer's reimbursement if the change of job location is made for the convenience of his employer. *Walter H. Mendel*, 41 T.C. No. 4 (docket No. 92537, Oct. 10, 1963).

Section 217 does not eliminate the exclusion found in present law, but instead attempts to put new employees on a parity with old employees by (a) allowing the new employee an "above-the-line" deduction for moving expenses and (b) denying the deduction to old employees for allowances or reimbursements that are not included in gross income. This approach, however, does not entirely eliminate the difference in the tax treatment of moving expenses reimbursed to old and new employees. Since the new statute does not attempt to change the rules as to exclusion of moving expense reimbursed to old employees, it is still possible that in some circumstances such employees will escape taxation where new employees would not. Thus, an old employee who qualifies under the rules set forth in Revenue Ruling 54-429, supra, would be entitled to exclude reimbursed moving expense without regard to the limitation contained in new section 217(e)(1) which allows a deduction only if the new place of work is at least 20 miles farther from the taxpayer's former residence than was his former place of work. Furthermore, whereas "moving expenses" deductible under section 217 are limited to the reasonable expenses of moving household goods and personal effects from the old to the new residence (including meals and lodging on the trip), the excludability of allowances and reimbursements has been held to extend to extraordinary living costs incurred by an old employee while his household effects are in transit. *John E. Cavanagh*, 36 T.C. 300 (1961). In its report, the Ways and Means Committee indicates that the question of whether the exclusion for old employees extends to expenses in connection with moving to a new job other than those included in the definition of "moving expenses" contained in section 217 is to be left to judicial decision. The door is thus left

open to expanding tax benefits to old employees but not to new employees. While the report indicates that no inference should be drawn from the section 217 definition of "moving expenses" in determining the extent of the exclusion by old employees, it may be that the courts will be reluctant to extend the exclusion in view of the announced congressional policy against discriminating between old and new employees.

Section 217(c)(1) provides that no deduction is to be allowed unless the taxpayer's new principal place of work is at least 20 miles farther from his former residence than was his former principal place of work, or if he had no former principal place of work, is at least 20 miles from his former residence. The technical explanation of this portion of the bill states that "for purposes of measuring distances under section 217(c)(1) all computations are to be made on the basis of a straight line measurement." Although cases can be envisioned in which such a rule might lead to unfair results, the rule seems entirely appropriate as a matter of administrative convenience. As the regulation under this section will most likely include a statement similar to that quoted above, it is suggested that the Senate Finance Committee report indicate that other methods may be utilized if the facts of a particular case so justify.

Section 217(c)(2) contains the second condition to the allowance of the deduction provided by section 217(a). Under this limitation, which does not apply if the employee is remborsed, no deduction is allowed unless the taxpayer is a full-time employee in the general location of his new principal place of work during at least 39 weeks of the 12-month period commencing on his arrival. This limitation gives no recognition to the fact that the inability to comply may not be voluntary; for example, as the result of death or disability. Therefore, it is suggested that consideration be given to amending section 217(c)(2) so as to provide that its limitation shall not apply in cases in which the taxpayer's failure to comply therewith was involuntary.

Section 213

Section 213 of the bill would amend section 264(a) of the code to disallow an interest deduction for indebtedness incurred or continued to purchase or carry life insurance, endowment or annuity contracts, (other than single premium contracts as to which section 264 already denies a deduction) pursuant to a plan of purchase which contemplates the systematic borrowing of the cash value of the contract. Under present law, tax savings are possible when a taxpayer each year borrows against the annual increase in the cash value of an insurance policy all or substantially all of the funds necessary to pay the premium on such policy. By this method of systematic borrowing, a taxpayer gets a deduction for interest incurred on such indebtedness without being required to include in income any portion of the offsetting increase in the cash value of the policy resulting from interest earnings.

In order to preserve the right to borrow on insurance policies for other than tax-saving purposes without the loss of the interest deduction, section 213 would add subparagraph (c) to section 264 to provide certain exceptions to the proposed rule. The exception subparagraph (c)(4) may, however, in certain instances nullify the effectiveness of the section. That subparagraph provides that the disallowance of the interest deduction will not apply if the indebtedness is "incurred in connection with [the taxpayer's] trade or business." The committee report states that while the disallowance will apply to all direct and indirect borrowing to pay premiums, including loans on other property and on a general line of credit, "the interest deduction is not to be denied where the indebtedness actually is to finance business obligations, rather than to carry insurance." Thus, it may be possible for a businessman to avoid the application of the new section simply by paying his premiums with funds that otherwise would have been used to meet business needs, and then meeting these business needs by money borrowed against his insurance policy. The requirement that the indebtedness be incurred "in connection with a trade or business" might arguably be satisfied in this way whether the business involved was conducted as a sole proprietorship or through a partnership or corporation. At best, difficult questions concerning the source of specific expenditures will be presented.

A possible solution to this problem would be to delete subparagraph (c)(4) and to broaden the exception in subparagraph (c)(3) to include indebtedness incurred to meet new or unusual business needs not theretofore financed out of the taxpayer's own capital, in addition to indebtedness incurred because of an unforeseen loss of income or an unforeseen increase in financial obligations.

Alternatively, subparagraph (c) (3) in its present form might be sufficient to accomplish this objective if the word "unforeseen" were eliminated.

Another problem exists under subparagraph (c) (1), which excepts from the loss of the interest deduction indebtedness incurred or continued in connection with the payment of insurance premiums if no part of four of the annual premiums due during the 7-year period beginning with the date of the first premium is paid by means of such indebtedness. The committee report does not indicate the reason for this exception but apparently it is an attempt to circumscribe the meaning of a plan of systematic borrowing. Query whether the exception is justified in light of the problems it will create. For example, earlier years may be barred by the time the fourth annual premium is paid. A taxpayer who does not borrow more than three of the first seven annual premiums will be able to borrow systematically from the eighth year on.

Section 214

Section 214 of the bill amends the 1954 code by amending existing section 421, and adding sections 422 through 425.[a]

The committee has the following comments on these provisions:

1. Section 422(a) provides (by reference to sec. 421) that in order to qualify for qualified option treatment the employee must for the entire period from the date of the granting of the option until 3 months before the exercise of the option be an employee of the corporation granting such option, a parent or subsidiary of that corporation, or a corporation (or a parent or subsidiary of such other corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. The report of the Ways and Means Committee states (at p. 67), with regard to the requirement that the option be exercised no later than 3 months after termination of employment, that military leave or sick leave will not disqualify an individual. Compare Revenue Ruling 59-140, 1959-1 (Cum. Bull. 92). However, the bill does not specifically provide for such an exception, and it would better assure the implementation of congressional intent if this exception were contained in section 422(a) (2) and section 423(a) (2), the parallel provision dealing with employee stock purchase plans. Furthermore, it would seem consistent with the policy behind such a provision to include a similar exception in the case of an employee on any type of temporary leave of absence. Such a provision would prevent unnecessary hardship for employees who take time off from regular employment to perform some governmental, educational, or charitable service.

2. Section 422(b) (5) provides that a qualified stock option by its terms must not be exercisable while there are any other options treated as outstanding. By virtue of section 422(c) (2), restricted stock options not terminated before January 1, 1965, are considered as being outstanding. This provision has a retroactive effect, which may have been unintended, with respect to an employee who has recently received a long-term restricted stock option which already has become valuable. In order for such an employee to be eligible to exercise a qualified stock option he may either have to exercise his restricted stock option earlier than is required by its terms or terminate his restricted stock option prior to January 1, 1965. In either event, he must give up a valuable property right. Consideration should be given to whether such effect was intended.

3. Usually, when an employee makes a disqualifying disposition of option stock, he will be deemed to have realized ordinary income to the extent of the excess of the fair market value of such stock at the time of exercise over the amount paid for such stock (Reg. sec. 421-6(d) (1)). Under existing section 421(f) of the code and section 421(b) such ordinary income is taxed in the year of the disqualifying disposition rather than in the year in which such option is exercised. However, under section 422(c) (1) (relating to options which were granted at a price less than fair market value at the time of grant), an employee may have already realized income at the time of exercise. It is, therefore, recommended that the bill be amended to provide that any amount previously includible in income under section 422(c) (1) will be taken into account in determining the amount of ordinary income and/or gain or loss realized on a disqualifying disposition of option stock.

[a] Reference to sections are to sections of the 1954 code as amended by the bill, unless otherwise indicated.

4. Section 424(b) in effect provides that a restricted stock option must have been granted prior to June 12, 1963. Many corporations have a practice of granting stock options on a regular basis. These corporations have been in a dilemma recently, i.e., whether to grant restricted stock options which qualify under existing law or whether to grant options which qualify under the proposed law which may or may not be enacted. In addition, many corporations which have issued stock options since June 12, 1963, issued such options under plans which would not qualify under sections 422(b)(1), 422(b)(2), or 423(b)(2); i.e., such options were granted under plans which were not approved by shareholders of the granting corporation within 12 months before or after the adoption of the plan, or such plans were adopted more than 10 years prior to the granting of the options. Consequently, it is recommended that either the effective cutoff date on restricted stock options be advanced to the date that the bill is enacted or that a provision be inserted which allows taxpayers to amend their options so as to qualify under the new act without change being considered a modification of the stock option. (For a similar type provision, see existing section 421(e)(2) of the code.) Moreover, if such an amendment is to an existing plan, pursuant to the terms thereof, and such plan has been approved by shareholders within 10 years, such plan should not have to be resubmitted to shareholders after such amendment.

5. Section 424(c)(2) provides that: "For purposes of this section, if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval."

There is no corresponding provision with respect to qualified stock options under section 422. Since it is contemplated that such options may be granted subject to stockholder approval of a "plan" within a year of grant, it is recommended that a parallel provision to section 424(c)(2) be added to section 422.

6. Section 425(c)(2) would reenact the provisions of existing section 421(d)(4)(B) of the code which provides that the termination of a joint tenancy constitutes a "disposition" of option stock if the recipient is a person other than the employee who acquired the stock upon exercise of a "restricted" or "qualified" option. It is understood that the Internal Revenue Service regards the death of the employee-joint tenant as constituting a disposition. Although, under present law, such employee need only remain alive for the 6-month or 2-year period (whichever is applicable under existing section 421(a)), under section 422(a) such employee would effect a disqualifying disposition if he died within 3 years from the date of transfer of stock to him pursuant to the exercise of a qualified stock option. It is, therefore, recommended that section 425(c)(2) be amended by providing that the transfer of stock held in joint tenancy due to the death of the employee-joint tenant does not constitute a "disqualifying disposition."

7. Under paragraphs (1) and (2) of section 422(b) it is not clear (i) whether there can be a "plan" which provides for the granting of an option to one employee and (ii) whether a "plan" is essential if an option for one or more employees is directly approved by shareholders. It is recommended that the Senate Finance Committee report clarify these points.

8. In commenting on section 422(c)(2) the report of the Ways and Means Committee indicates (p. A69) that if an option is exercisable in installments, each installment is to be considered as a separate option which will not be outstanding prior to the time it first becomes exercisable. However, there is nothing in section 422(c)(2), particularly the last sentence thereof, which allows each installment of a single option to be treated as a separate option. It is therefore recommended that section 422(c)(2) be amended to conform to the stated congressional intent.

Section 215

Under existing law if an installment contract for the sale or exchange of property entitled to long-term capital gain treatment does not specifically provide for interest, no portion of the deferred payments can be treated as representing interest to the seller with the result that he is taxed at capital gain rates. Speaking generally, section 215 of the bill would treat as interest to both seller and buyer portions of certain deferred payments received under contracts for the sale or exchange of property. It would apply where no interest was provided for or where the interest provided for was at least 1 percentage point lower than rates prescribed by regulations to reflect current interest rates.

This provision would treat as interest that portion of each installment payment to which it applied which "total unstated interest" under the contract bore to the total of such installment payments. "Total unstated interest" is defined as the

amount by which payments to which the section applies exceed the present value of such payments plus the present value of any interest payments provided for under the contract. In this regard subsection (d) of proposed new section 483 of the code, applies to payments which are indefinite as to time, liability, or amount, requiring a separate computation for each payment, including the determination of unstated interest attributable to it, as if it were the only payment due under the contract. The unstated interest thus would be computed from the date of the sale to the date of payment. For example, assume that in negotiating the sale of a business the parties are in substantial agreement as to the value of the tangible assets, but are far apart on their respective estimates of future earnings and the value to be attributed to good will. The parties finally agree that a substantial cash payment shall be made at the closing and that the remaining purchase price shall be computed solely by reference to earnings; no minimum payments being involved. A variation involves a payment of cash on the closing for the fixed assets and the delivery in the future of stock in an amount computed by reference to a formula based on earnings. In these cases it is unrealistic to treat the deferred payments as involving interest since no fixed amount ever was involved. Accordingly, the bill should be made inapplicable to cases where the liability or amount thereof was uncertain and limited to cases where the due date is uncertain.

The bill exempts sellers from the operation of this provision if the gain on the sale or exchange results in ordinary income. If a nonresident alien sells goods in the United States under such circumstances that the gain would be considered capital gain (i.e., he is not a dealer) any unstated interest would constitute income subject to tax and withholding. It would appear doubtful that tax should be imposed under such circumstances. If tax is to be imposed, the buyer should not be required to withhold.

Section 216

Section 216 of the bill substantially alters the tax treatment of personal holding companies to eliminate certain devices through which personal holding company income has escaped the penalty surtax. It also contains relief provisions whereby corporations covered for the first time by the new tax treatment will be able to liquidate without oppressive penalties. Finally, it grants certain relief to shareholders of foreign personal holding companies.

Under the basic change made by the bill, a corporation will constitute a personal holding company if 60 percent of its "adjusted ordinary gross income" constitutes personal holding company income, as against present law, under which a corporation is not a personal holding company unless 80 percent of "gross income" constitutes personal holding income. "Ordinary gross income" is defined as gross income reduced by gains from the sale of capital assets and gains from the sale of assets described in section 1231(b) of the code. Adjusted gross income is arrived at by reducing rents and mineral royalties included in "ordinary gross income" by the deductions for depreciation, depletion, property and severance taxes, interest and rent allocable thereto.

In general, while the approach taken to eliminate abuses is somewhat complex and introduces several new concepts such as "ordinary gross income" and "adjusted ordinary gross income," the proposed legislation appears to accomplish the indicated objectives. Moreover, in some areas the personal holding company provisions have, happily, been combined and simplified. The committee has the following comments on these provisions:

1. Section 216(k)(1) of the bill amends section 542(b) of the code (which, in certain cases, permits the determination of personal holding company status to be made on a consolidated basis) by substituting "adjusted ordinary gross income" for "gross income" each place it appears. This amendment would bar an affiliated group from determining its personal holding company status on a consolidated basis if any one member of such group derives 10 percent or more of its adjusted ordinary gross income from sources outside the group and 80 percent of such income from outside sources consists of personal holding company income. Because of the general tightening in the definition of personal holding company income, the possibility that affiliated groups will be accidentally denied the right to make these computations on a consolidated basis will be considerably increased. For example, if all excess working capital of an affiliated group is channeled to one member thereof who has the responsibility of investing such capital in short-term commercial paper, and if the interest income from such investments constitutes 10 percent of the investing corporation's adjusted ordinary gross income, personal holding company status for each member of

the group must be determined on a separate basis. It is therefore recommended that all determinations as to personal holding company status in the case of an affiliated group filing a consolidated return be made on a consolidated basis. In this connection, it is noted that the report of the Ways and Means Committee (p. 116) again characterizes an affiliated group as "a single economic unit for tax purposes."

2. Section 216(c) of the bill establishes certain conditions which must be met by a lending or finance company if it is to avoid classification as a personal holding company. Paragraph (6)(B) of section 542(c) would provide that certain personal holding income "plus the interest described in section 543 (b)(2)(C)" cannot exceed more than 20 percent of the ordinary gross income. The interest so described is interest on Government bonds held for sale by a dealer making a primary market for these obligations and interest on condemnation awards, judgments, and tax refunds. The purpose of this provision in paragraph 6(B) is not clear because section 543(b)(2)(C) eliminates such interest from "adjusted ordinary gross income." The report of the Ways and Means Committee (p. 77) states that these types of interest are not really passive in nature and are therefore excluded from the base upon which personal holding company income is computed. There seems no reason why the receipt of such interest should serve to subject a lending or finance company to the personal holding company tax.

3. Section 216(c) of the bill would permit a "lending company" which is actively engaged in the small-loan business (consumer finance business) under applicable direct State regulation to exclude from its personal holding company income (for purposes of qualification for exemption as a lending or finance company under section 542(c)(6)) dividends from an 80-percent-owned domestic lending or finance subsidiary if such subsidiary also meets the requirements of section 542(c)(6). It is not clear whether the use of "lending company" is intended to exclude a "finance company" which meets these conditions. Nor is it clear why this exclusion should be available only if the company operates under a State statute providing for the direct regulation of its business, unless such State statutes customarily require the creation of subsidiary companies. In this connection it is suggested that consideration be given to the more basic question of whether the existence of governmental regulation is in any way material to the classification of a lending or finance company as a personal holding company.

4. Section 216(d) of the bill defines the circumstances under which rent will be considered to be personal holding company income. Subparagraph (B) of section 543(a)(2) of the code would be amended to require that the amount of adjusted income from rents is to be included as personal holding company income unless adjusted gross income from rents constitutes 50 percent or more of adjusted ordinary gross income; and the personal holding company income for the taxable year, computed with certain modifications, is not more than 10 percent of ordinary gross income.

Since dividends are personal holding company income, an operating real estate company receiving a substantial dividend from an operating subsidiary may readily and quite accidentally find itself a personal holding company, if consolidated returns are not filed. Corporations actively engaged in the real estate business frequently operate property through numerous subsidiaries to achieve limitation of liability, or because this is required by lending institutions or by the FHA, and in other cases because of local and State tax considerations. It would seem reasonable that dividends from such subsidiaries, if they also meet the requirements of subparagraphs (A) and (B) of section 543(a)(2), should not be taken into account in determining whether personal holding company income for the taxable year is more than 10 percent of the ordinary gross income. Existing section 543(a)(9)(B)(ii) of the code (sec. 543(a)(4)(B)(ii) under the bill) contains a similar exemption applicable to 50-percent owned subsidiaries and a somewhat similar concept is embodied in section 542(d)(3) (as proposed under the bill). The percentage of stock required to be owned should be determined in light of industry practice. The same comments would seem applicable to section 543(a)(3), relating to income from mineral royalties.

5. Section 216(d) of the bill would apparently include in rents, which would be taken into account in determining whether the 10-percent limit of section 543(a)(3)(B) has been met, delay rentals paid to the owner of a mineral property. Since delay rentals are really a temporary substitute for royalties from leases of mineral, oil, or gas properties, and since the period during which they

are received is to a real extent outside the landowner's control, it would seem that they should be treated as mineral royalties and excluded in determining personal holding company income for purposes of section 543(a)(3)(B).

6. Section 216(d) of the bill requires that in order for the exclusion of mineral, oil, and gas royalties to be applicable, the sum of the deductions allowable under section 162 of the code must equal or exceed 15 percent of adjusted ordinary gross income. It would exclude from such deductions any compensation for personal services rendered by any shareholder. The provision appears to be unduly restrictive, particularly in the case of a company in the mineral, oil, or gas business in which there is public ownership of a minority stock interest. Compensation received by employees of the company would be tainted if they happened to inherit stock or purchase a few shares of the company on the open market or under a stock-purchase plan. This provision should be amended to exclude only compensation for services rendered by an employee if, directly or by attribution, he owns 5 percent of the stock of the corporation.

A similar change might be made in section 542(d)(2)(A) in the case of a lending or finance company, and in section 543(a)(4)(C)(i) in the case of a company deriving the bulk of its income from copyright royalties.

A comparable problem exists under section 543(a)(4)(A) where royalties are tainted if received in respect of works created in whole or in part by any shareholder. Consideration might be given to providing a comparable 5-percent stockownership limitation there.

In determining whether a corporation meets the 15-percent tests of section 543(a)(3)(C), only those deductions allowable under section 162 are taken into account. There would seem no reason why deductions allowable under existing section 404 should not be taken into account for this purpose. They are in actuality deductions for compensation paid, and are taken into account for a similar purpose under section 542(d)(2)(A). A similar comment applies to section 543(a)(4)(C).

7. Section 216(h) of the bill provides that most of the amendments made with respect to personal holding companies shall not apply in the case of certain corporations which liquidate before January 1, 1966. This exception, however, is inapplicable if the liquidation qualifies under section 332 of the code, unless the corporate distributee is liquidated in a complete liquidation to which such section 332 does not apply within a specified time. As drafted, section 216(h) of the bill would be inapplicable if a subsubsidiary liquidated into a subsidiary, which in turn liquidated into a parent which in turn liquidated within the specified period. There would seem to be no reason why this provision should not apply to the subsubsidiary in the case just described. Section 216(h) should be redrafted to apply to a corporation which liquidates in a section 332 liquidation, provided that the corporate distributee, or distributee of the distributee (or conceivably a distributee of a distributee of a distributee) is liquidated in a complete liquidation to which section 332 does not apply within the specified time period.

3. Because many corporations will for the first time become personal holding companies due to the changes made by the bill, a number of relief provision sare included. First, section 216(g) of the bill provides that certain corporations will be permitted to liquidate under section 333 of the code prior to January 1, 1966, and their shareholders: (i) will be taxed as having received class B capital gain to the extent of their accumulated earnings and profits prior to the date of liquidation; and (ii) will not realize gain to the extent that securities received in such liquidation were acquired prior to January 1, 1963. In other cases, certain corporations which had incurred "qualified indebtedness" prior to August 1, 1963, will be allowed a deduction, in computing their undistributed personal holding company income, for amounts paid or set aside to pay such debt. Furthermore their shareholders will be permitted the favorable application of section 333 described above if the corporation is liquidated in the year its qualified indebtedness has been satisfied or, under tests provided by the bill, the corporation is assumed to have funds sufficient to satisfy such indebtedness.

Neither the bill nor the report of the Ways and Means Committee makes it sufficiently clear whether "qualified indebtedness" is limited to debts on which the corporation has assumed personal liability or whether the term also includes debts to which property of the corporation is subject, although the provisions of section 545(c)(6) indicate the former. Since "assumed" debt and "subject to" debt are generally treated as equivalents throughout the tax law, they should both be included in "qualified indebtedness" unless there is some strong

countervailing policy consideration. One can easily imagine a situation where a corporation's property is only subject to a first mortgage but the corporation has assumed personal liability on a later subordinate second mortgage. Under these circumstances the first mortgage, even though not assumed, is a senior debt and should be included in "qualified indebtedness." Whichever way this question is resolved, it is most important that the treatment intended in the case of "subject to" debt be clearly indicated.

Paradoxically, it should be noted that shareholders in many cases will have to risk substantially worse tax treatment upon liquidation of a corporation than would otherwise be available in order to avail themselves of the relief granted by section 333(g). This will occur because there would seem no way of making a section 333 election conditioned upon qualification under section 333(g)(2)(B) or (3). (See pars. 10 and 11, infra.) If the election is made and it should prove, upon subsequent audit, that the corporation was not a corporation described in section 333(g)(2)(B) or (3), then the position of the Service might well be that the shareholders would be bound by their election and required to pay an ordinary income tax on the corporation's accumulated earnings and profits. See *Raymond* v. *U.S.*, 269 F. 2d 181 (6th Cir. 1959). There would seem no reason to deny ordinary liquidation treatment under existing section 331 where a corporation fails to qualify under section 333(g)(2)(B) or (3). This is particularly so since the failure to qualify may occur because of completely innocent error on the shareholder's part, such as a mistake in determining the amount of "qualified indebtedness" or the year in which it could or should be satisfied, the amount of an item of income or the year of its inclusion, or in the interpretation of the newly enacted personal holding company provisions. Therefore, section 333 should be amended to permit taxpayers, if they so wish, to make their election under existing section 333 conditional upon qualification under section 333(g)(2)(B) or (3). If this is not done, the value of the relief which Congress intended to provide under section 333(g) will be severely limited.

9. The bill permits the shareholders of certain corporations, which are assumed to be made subject to the personal holding company tax by the bill, to receive stock or securities in a section 333 liquidation occurring prior to January 1, 1966, without realization of gain if the stock or securities were acquired prior to January 1, 1963. There would seem to be no reason why this relief should not be accorded with respect to stock or securities acquired before the first date on which information was generally available to the public with respect to the inclusion of this relief provision in the proposed bill. The earliest date on which such information was generally available was approximately May 27, 1963.

A similar comment applies with respect to liquidations after December 31, 1965.

10. The bill permits certain corporations owning qualifying indebtedness on August 1, 1963, to liquidate after December 31, 1965, and receive favorable treatment for their shareholders under section 333, upon the satisfaction of certain conditions. Proposed section 333(g)(B)(iii) of the code requires that the corporation must liquidate before the close of the taxable year in which it "ceases to owe such qualified indebtedness or (if earlier) the taxable year * * *" in which the corporation's adjusted post-1963 earnings and profits exceed qualified indebtedness. The time at which adjusted post-1963 earnings and profits exceed qualified indebtedness is determined under section 333(g)(2)(C).

The requirement that liquidation occur in the taxable year in which the corporation ceases to owe such qualified indebtedness or in which its adjusted post-1963 earnings and profits exceed qualified indebtedness seems unduly strict. First, it is possible that under certain circumstances a corporation may cease to owe such indebtedness very late in the year, without clear prior knowledge that this event will occur, and without time to carry out the necessary corporate steps to bring about a section 333 liquidation. Second, it may be difficult to determine when adjusted post-1963 earnings and profits exceed qualified indebtedness, since a corporation will in many cases have to have available to its yearend closing figures in order to determine the amount of its earnings and profits. It is, therefore, recommended that proposed section 333(g)(2)(B)(iii) of the code be amended to cover liquidations occurring either in the year in which the conditions of clause (iii) are satisfied or during some reasonable period in the succeeding taxable year.

11. The risk of accidental disqualification under proposed section 333(g)(2)(B) and (C) of the code is also very high. This could occur, for instance, if subsequent adjustments of earnings and profits upon audit show that the conditions of section 333(g)(2)(C) were satisfied in a year prior to that in which the corporation had determined that these conditions were met. Since it is unlikely that either the corporation or the individual shareholders involved would have received any undue advantage in such cases, it would seem that the determination of the year in which adjusted post-1963 earnings and profits exceed qualified indebtedness made by the corporation should be accepted for this purpose in the absence of negligence or fraud.

12. Proposed section 545(c)(3) of the code defines "qualified indebtedness" with respect to the payment of which certain personal holding companies will receive a deduction in computing undistributed personal holding company income. The definition is now phrased in terms of indebtedness incurred before August 1, 1963. Since public information was generally unavailable as to content of these extremely complicated provisions on August 1, 1963, it would be appropriate to make this date the earliest date when such information was so available. In this connection it is noted that Revenue Release No. 63-26, dated August 9, 1963, tentatively selected August 6, 1963, as the cutoff date, and that such revenue release was no distributed by the major income tax publications for at least 1 week after the date of its issuance.

13. Proposed section 545(c)(5)(A) of the code reduces the amount of the deduction allowed in computing undistributed personal holding company income for amounts paid or set aside to pay qualified indebtedness by the amount of deductions "allowed" in taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, or amortization. The rationale of such reduction is based upon the fact that such deductions represent funds which can be used to repay "qualified indebtedness". See page 85 of the report of the Ways and Means Committee. It would seem appropriate, therefore, to add the word "depletion" to the above described deductions. The same comment is applicable to proposed section 333(g)(2)(C). See page 84 of the report of the Ways and Means Committee.

14. Proposed section 545(c)(3)(B) of the code provides that for purposes of determining qualified indebtedness there are to be disregarded any amounts which were "at any time after July 31, 1963, and before the payment or set-aside" owed to a person who at the time owned more than 10 percent in value of the taxpayer's outstanding stock. For this purpose the attribution rules of section 318(a) of the code apply. In view of the consistent use of the attribution rules of section 544 of the code throughout the personal holding company area, it would seem more appropriate that they be used here.

15. Although the bill does not change the manner in which the shareholders of foreign personal holding companies are taxed, section 216(j)(4) and (7) of the bill enacts temporary tax rules apparently intended to apply to the shareholders of a special limited class of, and possibly a single, foreign personal holding company. Moreover, this special relief is on a basis far more favorable than has ever previously been granted shareholders of these companies.

Paragraph (4) would permit a foreign personal holding company to be treated as a domestic corporation in order to avail itself of the favorable 1-month liquidation provisions of section 333 if the corporation is liquidated within 1 of the first 4 calendar months ending after the date of enactment of the bill. However, such a corporation is not treated as a domestic corporation for purposes of section 367 of the code, which is made applicable for this purpose. Thus, in order to enjoy these special benefits, a corporation must obtain a section 367 ruling in time to complete its liquidation before the 4-calendar-month deadline.

It is difficult to conceive of many foreign personal holding companies availing themselves of this favored treatment unless (i) the 4 months' requirement is lengthened, and (ii) the requirement that all of the stock of any such corporation so owned on August 15, 1963, by individuals and estates is elimiated. Furthermore, it would seem reasonable to question why this is appropration occasion for providing this relief for the shareholders of a small class of foreign personal holding companies on a basis more favorable than that previously provided for other persons similarly situated. Unless these provisions are amended and made available to taxpayers generally (by the deletion of subparagraphs (B) and (C) of section 216(j)(4) of the bill) there is a substantial question whether they represent an appropriate addition to our tax laws. If the policy underlying these provisions is sound, they should be added to the code and

made effective during a period of several years so that they can be availed of by taxpayers generally.

In addition, the committee has the following more technical comments on these provisions:

1. Clause (ii) of proposed section 543(a)(3)(C) of the code excludes as deductions in making the 15 percent of adjusted ordinary gross income computation, those deductions "which are specifically allowable under sections other than section 162." A comparable provision is included in section 543(a)(4)(C)(iii). In section 542(d)(2), this same exclusion is effected by somewhat different phraseology. To avoid future questions as to possible subtle differences of meanings in these provisions, uniform phraseology should be used to accomplish this exclusion.

2. Paragraph (B)(ii) of proposed section 543(a)(4) of the code eliminates certain dividends from consideration in determining whether more than 10 percent of the ordinary gross income of a corporation receiving royalties is personal holding company income. The exclusion applies to dividends received from a corporation in which the taxpayer owns "50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock * * *." This language differs somewhat from that used in a number of other code provisions where voting power tests are employed (e.g., secs. 269(a), 368(c), and 1504(a)) and also from the fair market value test of stock ownership employed in section 542(a)(2). To parallel the language used in these other sections, the reference should be to a corporation in which the taxpayer owns "stock having at least 50 percent of the voting power of all classes of stock entitled to vote and 50 percent in value of its outstanding stock * * *." A similar comment applies to section 542(a)(3).

The last portion of paragraph (C) of proposed section 543(a)(4) of the code might more accurately read "exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to property, income from which constitutes copyright royalties."

3. The material in parenthesis in proposed section 543(b)(1)(B) of the code would seem to add nothing to the meaning of this definition and should be stricken as a source of possible confusion.

4. Section 216(h) of the bill, which is not made a part of the 1954 code, is of sufficient importance to merit inclusion therein so that the many code provisions which are expressly made inapplicable to certain corporations for 2 years can be appropriately cross-referenced.

5. The use of the phrase "with respect to a contract" in proposed section 545(c)(3)(C) of the code is confusing and appears superfluous.

6. The second cross-reference contained in proposed section 1016(a)(21) of the code which is added to the code by section 216(j)(2) of the bill, should refer to "section 216(j)(5)."

Section 217

Section 217(c) of the bill provides rules for determining basis of oil and gas properties which were aggregated under present law, but which must be treated as separate under the proposed change. This provision does not amend the code, and hence will not be apparent to a person reading the code without an appropriate cross reference.

Section 220

Section 220 of the bill would add section 1250 to the code to tax as ordinary income gain attributable to accelerated depreciation in respect of real property, other than real property covered by section 1245(a)(3) of the code. Section 1250 as proposed differs from section 1245 in that it applies, if the property is held for more than 1 year, solely to the amount of depreciation in excess of that which would have been allowable under the straight line method, reduced by 1 percent for each month that the property is held in excess of 20 months.

Section 1250 is a section of broad application, establishing a general principle and is intended to override numerous other code sections of more narrow application. For example, section 1250 applies to certain liquidations under sections 331(a)(1), 333, 334(a)(2), and 337, to partial liquidations under sections 331(a)(2) and 346(a)(2), to redemptions under section 302, to dividend distributions to corporate and individual shareholders under section 301 and to sales or exchanges under section 337. Yet no adequate warning is given to the reader of some of these sections either through amendments or the insertion of cross-references.

The committee has the following comments on this provision:

1. Section 1250(c) defines "section 1250 property" to mean any real property (other than sec. 1245 property) "which is or has been property of a character subject to an allowance for depreciation provided in section 167." This language might be interpreted to exclude cases in which deductions are allowed in lieu of depreciation, such as amortization deductions under section 162 where the useful life of depreciable property constructed by a lessee is longer than the remaining term of his lease or the amortization deduction allowed a taxpayer under section 162 for costs incurred in acquiring a lease of land or other real property, although it is clear from the report of the Ways and Means Committee that Congress intended to cover such amortization deductions. It is suggested that section 1250(c) be amended by adding after the last word the phrase "or the allowance for amortization provided in section 162."

The report of the Ways and Means Committee states that property may lose its character as section 1250 property and become section 1245 property although property that is section 1245 property in the hands of a taxpayer can never become section 1250 property in the hands of such taxpayer. Section 1250 and section 1245, however, are silent on the subject of the treatment of gain on the disposition of section 1245 property that was *formerly* section 1250 property. Is the depreciation of such property attributable to periods in which it was section 1250 property subject to recapture under section 1250 or section 1245? If section 1250 does apply in this situation, does the holding period of the property include periods during which the property was section 1245 property?

2. Section 1250(b)(1) defines "additional depreciation" to mean the adjustments to basis in excess of "the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under the straight line method of adjustment." If a useful life or salvage value is used for the purpose of calculating the depreciation taken by a taxpayer, this useful life or salvage value will be used in determining the amount of depreciation that would have been taken pursuant to the straight line method. However, section 1250(b)(1) provides no guidelines for determining useful life or salvage value where the method of depreciation employed by the taxpayer is not based on useful life or salvage value. To determine, at the time of disposition, the useful life or salvage value that would have been assigned that property on the date acquired presents obvious practical problems.

The report of the Ways and Means Committee cites amortization of a leasehold improvement as an example of a method of depreciation in which "salvage value" is not used, but where a salvage value must be assigned in computing the depreciation that would have been taken under the straight line method. It is unclear whether this reference was meant to apply solely to the lessor and, if not, how it would ever be applicable to the lessee. In view of the ambiguity occasioned by references to depreciation as including amortization and by section 1250(b)(2), discussed below, specific statutory provisions governing amortization by lessors and lessees should be enacted.

Section 1250(b)(2) is apparently limited in application to lessees amortizing over the period of the lease, their capital investments in leasehold improvements or their cost of acquiring the lease. In such cases, renewal periods are included in determining the portion of the amortization deductions subject to recapture. The application of this subsection to a case where a lessee is depreciating his leasehold improvement does not, of course, make sense. Accordingly, this subsection should be expressly limited to lessees who amortize their leasehold improvements or their cost of acquiring a lease under section 162.

The reference in section 1250(b)(3) to depreciation allowed or allowable "to any other person" is apparently aimed at a case where the taxpayer acquired the property with a transferor's basis. However, the literal language of section 1250(b)(3) would require that prior depreciation reflected in the basis of the property be taken into account by the transferee even though the transferee acquired such property in a taxable transaction. The reference to deductions in respect of "other property" is apparently aimed at a case where the basis of the property disposed of was determined with reference to the basis of other property. The reference "to other property" creates confusion since its only application would be to transactions covered by section 1034, as special provisions are provided for the computation of additional depreciation at the time of exchanges described in sections 1031 and 1033 (sec. 1250(d)(4)).

The report of the Ways and Means Committee states that "additional depreciation" for periods after December 31, 1963, is reduced by the excess (if any) of the sum of the depreciation adjustments which would have resulted under

the straight line method attributable to periods before January 1, 1964, over the sum of the actual depreciation adjustments attributable to periods before such date. There is nothing in the bill to support this statement.

3. Section 1250(d) provides exceptions to the general rule of recognition of gain in section 1250(a)(1) on disposition of section 1250 property.

Section 1250(d)(3) provides an exception to the application of the recapture provisions for certain tax-free transactions, including section 351 transfers (except to the extent that "boot" is involved). However, this provision does not on its face apply to contributions by shareholders to the capital of corporations. In view of the general language of section 1250(a)(1), it may be desirable to have section 1250(d)(3) made expressly applicable to such contributions by reference to section 362.

Section 1250(b)(4) applies to transactions described in sections 1031 and 1033. Under section 1245(b)(4), if a taxpayer receives property which is not section 1245 property in an exchange in which no gain is recognized under section 1031 (or 1033), there is a recapture of depreciation to the extent of the fair market value of the nonsection 1245 property. On the other hand, under section 1250 (d)(4) there is no recapture of depreciation in such situation if the fair market value of the section 1250 property received in the exchange equals or exceeds the additional depreciation which would otherwise be subject to tax. There is no apparent reason for this difference in treatment.

Furthermore, there is no reason for treating stock purchased (in addition to section 1250 property) in a section 1033 transaction differently from the case where nonsection 1250 property other than stock is purchased. As the bill now reads, there would be a recapture of depreciation where stock is purchased while there may be no recapture where nonsection 1250 property other than stock is purchased.

Section 1250(d)(4)(D) incorporates the last sentence of section 1033(c), with enumerated adjustments, to determine the basis of property acquired to replace section 1250 property in a transaction described in section 1033(a)(3)(A). Section 1250(d)(4) further provides that for other transactions described in sections 1031 or 1033, rules consistent with the above method of determining basis are to be applied. Section 1250(d)(4)(D) is designed primarily to cover transactions in which nonsection 1250 property is acquired in addition to section 1250 property. A good deal of the drafting complexity and the difficulty in application could be eliminated by adopting express basis provisions for transactions described in sections 1033 (and sections 1031, 1071 and 1081). The following is a suggested new section 1250(d)(4)(D):

"(D) BASIS OF PROPERTY ACQUIRED.—If section 1250 property is acquired in a transaction described in section 1033(a)(3)(A), the basis of such property shall be the cost of such property decreased by the amount of gain not recognized. If property that is not section 1250 property is acquired in addition to section 1250 property in a transaction described in section 1033(a)(3)(A) the basis of the properties acquired shall be determined by reducing the cost of such properties in the following manner:

"(i) The cost of the section 1250 property shall be reduced by the amount of gain not taken into account under subsection (a)(1) by reason of this paragraph, and

"(ii) The basis of the section 1250 property computed under (i) and the cost of the property that is not section 1250 property shall be reduced by the remaining unrecognized gain allocable to the properties in proportion to the basis of the secti n 1250 property computed under (i) and the cost of the remaining property. In the case of properties acquired in any other transaction to which this paragraph applies, in computing the basis of such properties, the words 'fair market value' shall be substituted for the word 'cost'.

Section 1250(d)(4)(E) provides that in sections 1031 and 1033 transactions, the additional depreciation not taken into account at the time of the exchange shall be considered to be additional depreciation with respect to the property acquired in the exchange. There is no carryover holding period with respect to the additional depreciation as computed at the time of the exchange nor is there any carryover holding period with respect to depreciation taken thereafter on the property acquired. Thus a taxpayer acquiring property in a section 1031 or 1033 exchange is in a substantially worse position than a person acquiring property in a transaction described in section 1250(d)(3). Consideration should be given to the elimination of this discrimination.

4. Section 1250(f) provides special rules for determining the amount of recapture on the disposition of property that has been improved. Section 1250 (f)(4)(C) defines "improvement" to mean "any addition to capital account for such property after the initial acquisition or completion of the property." The report of the Ways and Means Committee indicates that transactions involving adjustments to basis of property, such as a partial recognition of gain in a transaction described in section 1250(d)(3), which are not ordinarily thought to involve improvements, are nevertheless deemed to be improvements within section 1250. A more definite reference to this concept of improvement should be made in section 1250(f)(4)(C). Moreover, a literal reading of the term "initial acquisition" would make this section apply to improvements made by other taxpayers with respect to this property, regardless of whether the taxpayer acquired the property in a taxable or nontaxable transaction. It is suggested that the definition of "improvement" be amended to delete the words "after the initial acquisition or after completion of the property" and to substitute therefor the words "after the beginning of the holding period determined under paragraph (e)(1)."

An improvement is deemed to be a separate improvement if the requirements of section 1250(f)(4) (A) and (B) are satisfied. If the improvements within a taxable year are larger than the minimum requirements of section 1250(f) (4)(B), such improvements are taken into account in determining whether the improvements for a 36-month period satisfy the requirements of section 1250(f) (4)(A). If the minimum requirements of these provisions are met, each improvement that satisfies the minimum requirements of section 1250(f)(4)(B) will be deemed to have been acquired on the date it was placed in service. If an improvement under these circumstances is less than the minimum requirements of section 1250(f)(4)(B), it will be deemed to have been placed in service on the first day of a calendar month which is closest to the middle of the taxable year. After the date of acquisition is determined for each element, the amount of recapture on a disposition of the property is determined according to section 1250(f)(2) which provides that the additional depreciation and its applicable percentage shall be computed separately for each element.

Section 1250(f) requires not only that a taxpayer retain records for each item of real property and recompute the depreciation that would have been taken if the straight line method had been used, but also that the taxpayer be able to recompute the depreciation for improvements of the real property as if the improvements were separate items of property. The necessity for these provisions is questionable in view of the technical difficulties involved.

5. It should be provided that on the casual sale of section 1250 property on the installment method, the section 1250 income is realized proportionately with each installment payment rather than out of the earliest installment payments which cover the amount of section 1250 income.

Section 221

Section 221 of the bill would provide new rules for income averaging. At the present time, sections 1301 through 1307 of the code permit the spreading of gross income over more than 1 taxable year if a substantial part thereof, arising from activities or events extending over periods in excess of 1 year, was received or accrued in a single taxable year. The existing rules apply only in a number of selected cases pertaining to compensation from long-term employment, income from inventions and artistic work, back pay and damages for patent infringement, breach of contract and injuries under the antitrust laws. The gross income is spread as nearly as possible over the years in which it was produced.

Section 221 of the bill proposes to substitute for the existing rules a new rule of general applicability which would reduce substantially the effect of annual variations in taxable income (as distinguished from gross income) by averaging taxable income over a span of 5 years. According to the report of the Committee on Ways and Means, the reasons for the proposed change are (*a*) principles of "tax equality" which call for equal taxation without regard to wide annual variations of income over years or to the type of income received; and (*b*) the "complexity" of present averaging provisions which require the recomputation of taxable income and of taxes of prior years as well as of the taxable year.

Under proposed section 221 income averaging is accomplished by allowing an "eligible individual" to have taxed at lower brackets the amount ("averageable amount") by which the "adjusted" taxable income for the current year

("computation year") exceeds 133⅓ percent of the average taxable income (as adjusted) of the 4 preceding years ("average base period income"). The tax on averageable income is determined by adding one-fifth of averageable income to 1⅓ times the average base period income, computing a tentative tax on the one-fifth and then multiplying the tentative tax by 5 to determine the final tax on the averageable income. Averaging is available only where the averageable income exceeds $3,000.

The proposal differs from existing law in two major respects; namely, (a) the absence of any requirement that a given percentage of income be received in the computation year, and (b) the absence of a requirement that the income be earned over a minimum stipulated period of months.

The new rule proposed by section 221 is exceedingly complex and in many areas difficult of application because of the limitations introduced for the purpose of excluding from averaging certain types of income and reducing variations in income due to change in status of the taxpayer. As a result of these limitations, it is possible that the computation year may have as many as seven distinct "tiers" of income upon which separate tax must be computed.

Proposed section 1302 of the code deals with the computation of averageable income which is defined as the amount by which the adjusted taxable income of the computation year exceeds 133⅓ percent of average base period income. It provides that averageable income must be reduced by the excess, if any, of the average base period capital gain net income over the capital gain net income of the computation year. Since, with this exception, capital gains are excluded by other provisions of the bill from consideration in base period net income and from taxable income of the computation year, no reason is seen for the adjustment required by section 1302(a)(2). The committee recommends that this adjustment be eliminated and that capital gains be excluded from any consideration in the determination of average base period net income or average taxable income of the computation year.

Proposed section 1302(b)(2) of the code provides that the taxable income of the computation year must be reduced by the amount of income derived from gifts, devises, or inheritances where such gifts, etc., have been received either in the computation year or in any of the 4 base period years. If income attributable to such property is not in excess of $3,000, the exclusion does not apply. Furthermore, the bill provides in this regard that unless the taxpayer otherwise establishes to the satisfaction of the Commissioner the actual amount of the net income from such property the amount thereof shall be presumed to be 6 percent of the fair market value of such property determined without regard to any increase or decrease in such fair market value since the time of receipt of such property. The bill also provides that income attributable to an interest in property received as a gift, bequest, etc., shall be excluded in the determination of base period net income.

It is by no means clear that the adjustment for income received from donated or inherited property should be retained. Its inclusion may result in exceedingly difficult identification problems such as were encountered a number of years ago in connection with th previously taxed property provisions of the Federal estate tax. Moreover, inequities result inasmuch as the effect of the proposed provision is to require no adjustment in the case of income received from a $50,000 bequest but to require adjustment where the bequest is in excess of that amount. Additional inequities are found in the use of the arbitrary 6-percent-income determination and in the fact that no adjustment is permitted to compensate for a reduction in the fair market value of the inherited property between the time of its receipt by the taxpayer and the computation year. Section 1302(b)(2), as proposed, also places a substantial burden of proof upon the taxpayer to establish that the actual amount of income received from inherited property is less than 6 percent of the original fair market value thereof.

Proposed section 1302(c)(2)(A)(i) of the code provides that these shall be added back to the taxable income for each base period year the amount excluded from gross income under sections 911 and 931 of the code relating to earned income from foreign sources and from U.S. possessions. Correspondingly, proposed section 1304(b)(3) has the effect of including such foreign income in the taxable income of the computation year irrespective of the provisions of section 911 or 931. It would be more equitable to provide that averageable income in the computation year should be reduced by the amount by which the average base period net income which was included under section 911 or 931 exceeded the amount of such income received in the computation year.

Proposed section 1303 of the code describes those individuals who are eligible to choose the benefits of income averaging and excludes from the category of "eligible individuals," nonresident alien individuals and an individual who during any base period year furnishes (together with his spouse) less than one-half of his support. Subparagraph (A) of proposed section 1303(c)(2) includes, however, in the category of eligible individuals, one who has attained the age of 25 before the computation year and who during at least four of his taxable years beginning after he attained the age of 21 was not a full-time student. The exclusions from eligibility contained in section 1303 will be difficult of application and give rise to many inequities, and no reason is apparent for denying eligibility to a taxpayer solely because he failed to furnish one-half of his support. Moreover, under the statutory provisions as proposed, a full-time student who is not self-supporting would be ineligible if single but would be eligible if married to a wife having a substantial income. It is believed that the intent of section 1303 is to avoid averaging in the case of the new worker or new taxpayer who has had no income during the base period years. Accordingly, it is recommended that section 1303 be amended so as to provide that all taxpayers, other than nonresident alien individuals, will be eligible for income averaging and that the average base period net income of taxpayer who did not file returns in each of the 4 base period years should be the actual average of the taxable income of the years of the base period in which returns were filed or $3,000, whichever is the greater amount. In the alternative, it is recommended that section 1303(c) be eliminated since its actual effect is de minimus.

The rules of proposed section 1304 of the code on computation of income of married taxpayers lead to somewhat confusing and arbitrary results. If a married taxpayer files a separate return in the computation year, he must compute his base period income for averaging purposes at the larger of his separate income or 50 percent of his and his spouse's combined income during each base period year, even if (i) taxpayer filed separate returns in all of the 5 years; (ii) he was not married to such spouse in one or more of the base period years; and furthermore, (iii) if taxpayer was married to another spouse in a base period year with income larger than the person who is his spouse in the computation year, taxpayer's minimum income of the base period year in question equals at least 50 percent of his and his ex-spouse's combined income. Presumably, if a joint return is filed in the computation year the same rules apply, notwithstanding the exception in subsection 1304(c)(1) which seems to be without any particular significance. It is recommended that section 1304(c) be changed to provide that—

1. No inclusion of income of a spouse is required where taxpayer filed separate returns in the base period and in the computation year.

2. If husband and wife file a joint return in the computation year, their taxable income in such year must be compared with their combined taxable income in the base period years. However, contrary to section 1304(c), if husband or wife or both were married to another spouse in one or more base period years, his or her minimum income in any such base period year shall be computed by reference to the income of such ex-spouse only, if reported in a joint tax return by husband or wife and such ex-spouse for such year.

3. If a taxpayer files a separate return for the computation year, his minimum taxable income for a base period year for which taxpayer filed a joint return with a (present or former) spouse shall not be less than 50 percent of the taxable income which was reported in such joint return. Contrary to section 1304(c) no comparison need be made between the income so reported in such joint return and the combined income that would have been reported had taxpayer been married to the other spouse or one of the other spouses that he was married to during the 4 years under comparison.

Section 223

Section 223(a) of the bill would add a new part II to chapter 6B of the code (secs. 1561–63), the apparent purpose of which is to reduce the value of the surtax exemption to medium and large business enterprises conducted in multiple corporate form, while preserving the benefit of the lower corporate tax rate on the first $25,000 of taxable income to "small business." However, it would appear that although proposed sections 1561 through 1563 of the code will reduce the benefit of multiple surtax exemptions to "big business" from the present $5,500 per corporation ($6,500 per corporation under the bill after 1964)

to $5,000 if the election prescribed in section 1562 is availed of, small business groups operating through multiple corporations will be required to make an election (which may eventually become binding for a 5-year period) between being limited to one surtax exemption or else paying an additional 6-percent tax on the first $25,000 of taxable income of each member of a controlled group of corporations. Assuming a 22-percent normal tax rate on the first $25,000 on corporate taxable income and a 48-percent tax rate thereafter, each controlled group whose aggregate annual taxable income is in excess of $32,500 will pay a small tax by complying with the election procedure contained in section 1562 (and paying a 28-percent tax on the first of the $25,000 of taxable income of each member of such group) in lieu of being subject to provisions of section 1561 pursuant to which such group would be limited to one surtax exemption. Thus any controlled group whose aggregate taxable income fluctuates above and below $32,500 (usually considered a small business) may be penalized by the provisions of section 1561–63, whereas medium and large concerns operating in multiple corporate form with an aggregate annual taxable income consistently in excess of $32,500 will always avail themselves of the election contained in section 1562, notwithstanding the fact that the first $25,000 of taxable income of each member of such group will be taxed at 28 percent after 1964.

In view of the divergence between the stated purpose of sections 1561 through 1563 in the report of the Ways and Means Committee and the actual results under such provisions as now drafted, it is recommended that section 1562 be amended to delete the provisions relating to the binding character of the election.

Proposed section 1561(b) of the code provides, with respect to a corporation having a short taxable year not including a December 31 (and which is a component member of a controlled group), that the surtax exemption is to be computed in accordance with the provisions of section 1561(a)(1), i.e., the surtax exemption will be equal to the quotient obtained by dividing the number of members of such group into $25,000. With respect to corporations having such short taxable years, there does not appear to be any reason why they should not be entitled to the benefit of the election provided by section 1561(a)(2), i.e., being able to allocate the surtax exemption among members of the controlled group other than by equally dividing such exemption among the members of such group.

Proposed section 1562(b)(1) of the code absolves a controlled group from the additional 6-percent tax on the first $25,000 of taxable income if only one member of such group has taxable income. If section 1562 is not amended as heretofore suggested, it would appear more appropriate to base the exclusion from tax upon the condition that the aggregate taxable income of such group be not in excess of $25,000.

The definition of "excluded member" contained in proposed section 1563(b)(2) of the code should include (i) a corporation to which existing section 931 of the code applies if such corporation has no income from sources within the United States and (ii) a corporation subject to the provisions of existing sections 1371 et seq. of the code (subch. S), all of whose income is taxed to shareholders. Since neither of such corporations is subject to tax they should not be included for purposes of determining the allocation of the surtax exemption under section 1561.

For purposes of determining the existence of a parent-subsidiary controlled group, proposed section 1563(c)(2)(A)(i) of the code excludes from the computation (and thereby facilitates the finding of the existence of such group) subsidiary stock "held by a trust which is part of a plan of deferred compensation for the benefit of the employees of the parent corporation or the subsidiary corporations." To determine the existence of a brother-sister group of controlled corporations, section 1563(c)(2)(B)(i) excludes stock of a corporation "held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if such trust is for the benefit of the employees of such corporation." There does not appear to be any reason for the difference in language.

Proposed section 1563(c)(2)(A)(iii) of the code excludes, for purposes of determining the existence of a parent-subsidiary controlled group, stock owned by an employee of a subsidiary if such stock is subject to restrictions (i) which run in favor of the parent or subsidiary corporation, and (ii) which substantially restrict or limit the employee's right to dispose of such stock. In section 1563(c)(2)(B)(ii), for purposes of determining the existence of a brother-

sister controlled group, such an employee's stock is not excluded if similar restrictions are imposed upon stock owned by the common owner. There does not appear to be any reason for not similarly including such employee's stock in the computation regarding the existence of a parent-subsidiary controlled group if similar restrictions are imposed upon stock held by a person described in section 1563(c)(2)(A)(ii).

Proposed section 1563(e)(5)(B) of the code contains an exception with respect to the spouse attribution rule which exception is applicable if, among other things, one spouse (i) does not directly own stock in a corporation controlled by the other spouse, (ii) is not a director or employee of such corporation, and (iii) does not participate in the management of such corporation at any time during the taxable year. This last condition would appear difficult to prove or disprove in view of the normal discussions between husband and wife, both of whom are engaged in business, and should be omitted. However, even if one spouse is not an employee or director of a corporation whose stock is controlled by the other spouse, attribution should apply if the former has performed management services as an independent contractor and received valuable consideration therefor from such corporation.

The table of contents with respect to existing sections 1551 and 1552 should be amended by designating such sections as part I of chapter 6B.

Section 301

This section amends section 3 relating to the optional tax for persons whose adjusted gross income is less than $5,000. Separate tables are now provided as follows:

1. Single person, not head of household.
2. Head of household.
3. Married persons filing joint returns.
4. Married persons filing separate returns, 10-percent standard deduction.
5. Married persons filing separate returns, minimum standard.

In the case of married persons filing separate returns, the method of computing the standard deduction must be consistent for both taxpayers. (Ordinarily, in the case of any one taxpayer, the table which results in the lower tax is the proper one to use.) Because of the multiple tables provided by the section, it will probably be necessary to provide a place on the tax return where the taxpayer can indicate which table he is using for the computation of his tax.

Section 6014 is amended to provide that married persons filing separate returns shall not get the benefit of the minimum standard deduction if they file a form of return whereunder the tax is computed by the Commissioner (i.e., form 1040 A).

Since the persons who are most likely to benefit by the new provisions relating to the minimum standard deduction are those in the lower-income brackets, it seems that the return filing process is being made unduly complicated for such individuals if by chance they happen to be married and desire to file separate returns.

It is recommended that the Secretary be given authority administratively to permit the use of the minimum standard deduction for married taxpayers who file separate returns provided the necessary information concerning the other spouse is submitted to the Internal Revenue Service. This could be accomplished, for example, by providing for a form on which the necessary information for each spouse could be inserted, thereby enabling the Internal Revenue Service to review both returns at the same time and compute the lowest possible tax. This would not, of course, solve the problem of the married taxpayer who either does not want his spouse to see the information relating to his income or is not living with his spouse. The committee believes that the latter cases would represent a small minority of married taxpayers who do not wish to file joint returns.

The CHAIRMAN. Also, I am placing in the record a copy of a letter by Mr. G. Keith Funston, addressed to Senator Paul H. Douglas, transmitting a technical memorandum developed by the New York Stock Exchange staff, reconciling the estimates of 1959 capital gains realized on stock discussed during Mr. Funston's appearance on October 25, 1963 (pt. 2, p. 911 of printed hearings on H.R. 8363).

(The letter and memorandum referred to follow:)

NEW YORK STOCK EXCHANGE,
New York, N.Y., November 27, 1963.

Hon. PAUL H. DOUGLAS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR: During my testimony before the Senate Finance Committee, you expressed concern about what seemed to be a difference between Treasury and Louis Harris estimates for capital gains on corporate stock realized in 1959. To resolve this apparent difference, members of our research department met with members of the Treasury's tax analysis staff.

While exact figures were not developed, the attached technical memorandum developed by the exchange staff, along lines discussed with the Treasury, shows that a satisfactory reconciliation is possible. Thus, we see no strong grounds for questioning techniques and reasonableness of Harris findings or projections of unlocking and revenue contained in my statement before the Finance Committee.

Sincerely yours,

G. KEITH FUNSTON.

RECONCILIATION OF TREASURY AND LOUIS HARRIS ESTIMATES OF 1959 CAPITAL GAINS REALIZED ON STOCK

The Treasury figure of $5.1 billion is taken from the special capital gains study of the Internal Revenue Service.[1] While this figure is identified as "Corporation stocks, including rights," it is not all inclusive and does not include all the corporate stock realizations which make up the $10.7 billion Harris figure.[2]

To measure total corporate stock realizations, it is necessary to add to the IRS figure:[3] Distributions from regulated investment companies, some percent of share of gain or loss from partnerships and fiduciaries, and some percent of other assets.[4] The first of these is entirely corporate stock, while the other two include some unknown but probably substantial amount of corporate stock. The IRS special study excludes figures available from other "Statistics of Income" publications, while the Harris study includes them: for example, short-term gains, and personal holding company long- and short-term gains. Conservative adjustments of the various IRS figures account for nearly $3 billion from these sources alone.

Moreover, an interview study such as the Harris report naturally differs somewhat in coverage from information reflected on tax returns. The more basic dissimilarities include those of definition, conceptual differences, and items not subject to accurate quantification, such as sampling errors, nonreporting, etc.

Other adjustments to the IRS figure include short- and long-term gains retained and taxed to estates and trusts, short- and long-term gains that are legitimately nonreported and some that are misreported, etc. Taking these factors, plus adjustments to Treasury figures into account, reduces the apparent "gap" substantially. The actual difference may well be less than $1 billion if Treasury and Harris figures are off by as little as 5 percent—a figure well within acceptable estimating errors.

The CHAIRMAN. The first witness is Mr. Karl R. Price, of Alvord & Alvord.

The Chair would like to make this statement to the witnesses: When hearings were scheduled for today it was not known that the Senate would be in recess. I want to express my apologies for the fact that so many Senators are out of town.

Mr. Price, please go ahead.

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[1] "Sales of Capital Assets Reported on Individual Income Tax Returns," Statistics of Income, 1959.

[2] "A Study of the Revenue Effects of Possible Modification of Present Capital Gains Tax," by Louis Harris & Associates, Inc.

[3] All adjustments refer to table 2, p. 10 of the IRS report.

[4] The inclusion of corporate stock under various headings is reported under "Types of capital assets" on pp. 5 and 6 of the IRS report.

Senator DOUGLAS. Let me say the chairman has been devoted to his duty and has shown great energy and public spirit in coming to every session.

The CHAIRMAN. Thank you very much. The Senator from Illinois has certainly been very faithful at the hearings. He has been here every day.

STATEMENT OF KARL R. PRICE, ATTORNEY AT LAW

Mr. PRICE. Mr. Chairman, my name is Karl R. Price. I am a member of the law firm of Alvord & Alvord, of this city. This statement which I am about to make pertains solely to the effective date of section 215 of the bill which relates to interest on certain deferred payments. Under present law as it has existed for the past 50 years, if the buyer and seller of a capital asset agree on a price to be paid in installments over a period of time, without interest, the terms of their agreement will be followed in determining the income tax consequencss of the transaction. That is, the entire amount of the agreed price will be used to compute the seller's gain and the buyer's cost; and the seller will not be required, and the buyer will not be permitted, to treat any part of the price as interest.

Section 215 of the bill would change that rule. It would provide that a certain part—computed at a prescribed discount rate—of what the parties to a sale have agreed on as the sales price shall be treated for income tax purposes as interest. The new rule would increase the tax liability of the seller by treating part of the sales price as interest income rather than as capital gain, and concurrently would reduce the tax liability of the buyer by treating the same amount as an interest deduction rather than as an investment in a capital asset. Thus, in the ordinary case the new rule would have no substantial net effect on Government revenues, but would alter the terms of the sale as between the parties themselves.

In such a situation the Government has no substantial interest in a retroactive or even in an immediate application of the new rule, but the public has a very substantial interest in being afforded adequate notice of it.

What does adequate notice require under these circumstances? First, it requires that the new rule as eventually and finally formulated should be applied only to transactions entered into after the date of enactment, since until then the public cannot know whether the bill will be passed, or whether the pertinent section will be eliminated from the bill or modified.

Second, it requires that there be a period after enactment sufficient for the public generally to become informed as to the terms of the new provision, and sufficient to permit transactions which are in an advanced stage of negotiation to be reconstructed in the light of the new provision.

Under these principles, section 215(d) of the bill, which in its present form would apply the new rule to sales made after June 30, 1963, should be amended so that it will apply only to sales pursuant to agreements made more than 30 days after the date of enactment.

I sincerely hope the committee will give consideration to the suggestion. That is all I have to offer at this time. I thank you for the opportunity to appear.

The CHAIRMAN. Thank you, Mr. Price.

Senator Douglas?

Senator DOUGLAS. Mr. Price, your testimony has been directed to section 215?

Mr. PRICE. Yes, sir.

Senator DOUGLAS. Do you have any interest in section 216 on personal holding companies?

Mr. PRICE. I do not.

Senator DOUGLAS. Do you know anything about foreign personal holding companies?

Mr. PRICE. I do know something about foreign personal holding companies; yes, sir.

Senator DOUGLAS. Are you opposed to the provisions in the bill as it comes to us dealing with foreign personal holding companies?

Mr. PRICE. I have not actually given any study to those provisions. I am not quite clear on what provisions it is that the Senator refers to.

Senator DOUGLAS. Well, section 1014(b) (5) is the present provision.

Have you read the analysis prepared by the staff on this section as follows:

> The bill amends the Internal Revenue Code to provide that when stock in a corporation which was a foreign personal holding company, for its last taxable year before enactment of the bill, is transferred at death—

I wonder if we could get a copy of this report for Mr. Price so that he can follow it? This is page 83.

Mr. PRICE. I have a copy of the staff description.

Senator DOUGLAS. That is right.

Mr. PRICE. Yes, sir.

Senator DOUGLAS. Page 83.

Mr. PRICE. Page 82?

Senator DOUGLAS. Page 83. I will start again, I will go back to the beginning:

> Under existing law when a decedent leaves stock in a personal holding company, the basis of such stock to his estate (or to the person inheriting it) is the decedent's basis or the fair market value at the time of death, whichever is less.

Then there is a reference to this provision in the Internal Revenue Code which I quoted. The staff report goes on to say:

> The bill amends the Internal Revenue Code to provide that when stock in a corporation which was a foreign personal holding company, for its last taxable year before enactment of the bill, is transferred at death and the decedent's basis for such stock is less than its fair market value the basis of the stock shall be increased by the amount of Federal estate tax attributable to the net appreciation in value. This may be illustrated by assuming that a decedent leaves stock of a foreign personal holding company which had a cost basis to him of $100,000 but had a fair market value at death of $1,100,000. Under the amendments made by the bill the basis of this stock to the estate will be $100,000 plus the amount of Federal estate tax attributable to the $1 million appreciation in the stock.

I wondered if you agree with this as a description and whether you favor the provisions of the bill on this point.

Mr. PRICE. I cannot say whether I agree with it as a description. Not having read the provision of the bill, I would assume that it is

an accurate description. I know that my senior partner has an interest in this provision, and I have not made a study of it myself. I would say that I was in favor of it.

Senator DOUGLAS. Do you feed there has been an abuse in the matter of foreign personal holding companies?

Mr. PRICE. Whether there have been abuses in foreign personal holding companies in some cases I really am not prepared to say. Of course, the ordinary rule today that applies to foreign personal holding companies is that the stockholder is required to pay income taxes at his individual rates on the full amount of an undistributed income, so that he actually gets no tax benefit out of maintaining a foreign personal holding company in existence.

The only reason why foreign personal holding companies are maintained in existence today is because the stockholder does not want to face the heavy burden of capital gain taxes that would ensue on the liquidation of the company. But currently, year by year, he is required under existing law to pay Federal income taxes at the regular surtax rates.

Senator DOUGLAS. Does the treatment of foreign personal holding companies differ from the treatment of domestic personal holding companies?

Mr. PRICE. Yes, sir; it does. Domestic——

Senator DOUGLAS. In what respect?

Mr. PRICE. Domestic personal holding companies are taxed on their undistributed income as separate corporations at a specified penalty rate.

Senator DOUGLAS. They are taxed at 52 percent in the case of receiving dividends, if they are outside the scope of personal holding companies, but if they are real personal holding companies but disguised as not being personal holding companies, then they will be taxed on the dividends received, they will be taxed at 52 percent of 15 or 7.8 percent; isn't that true?

Mr. PRICE. That is correct; yes.

Senator DOUGLAS. That is, if they have less than 80 percent of their income, as that may be defined, from dividends.

Mr. PRICE. Yes.

Senator DOUGLAS. How does the treatment of foreign personal holding companies differ from this?

Mr. PRICE. The foreign personal holding company treatment is handled under entirely different provisions, and the treatment, in substance, is that the income of the foreign personal holding company is taxed to the stockholder. It is not taxed in the hands of the corporation.

Senator DOUGLAS. It is not taxed to the corporation.

Mr. PRICE. It is not taxed to the corporation. The corporation, being a foreign corporation, I assume is not taxed on the ground that it is not subject to U.S. tax jurisdiction, except on whatever part of its income may be from U.S. sources. That, of course, is taxed as income from U.S. sources in the same manner as any income from U.S. sources is taxed.

Senator DOUGLAS. Suppose a company is set up in Nassau, in the Bahamas, and suppose it has an income of $1 million a year from dividends, and an income of $300,000 from other sources. This would mean

that it would not be a personal holding company—if it were a domestic company, isn't that true—$300,000 is more than 20 percent of $1,300,000.

Mr. PRICE. If the $300,000 is not personal holding company income I think that is right. I do not recall——

Senator DOUGLAS. Would it be a personal holding company if its location, what is the legal phrase, its situs, is in Nassau?

Mr. PRICE. It would be a foreign personal holding company if it were incorporated in Nassau.

Senator DOUGLAS. Would the taxation be more severe than if it were a domestic company?

Mr. PRICE. If it were a foreign personal holding company.

Senator DOUGLAS. That is what I mean, it would not be a personal holding company under the present law. It would be under the House bill.

What I am trying to get at is what is the difference in treatment of a foreign personal holding company now as compared to a domestic personal holding company?

Mr. PRICE. Well, the difference is that the income of a foreign personal holding company is taxed in the hands of the stockholder.

Senator DOUGLAS. Is the definition the same in both cases; namely, that you must have 80 percent of the income from dividends?

Mr. PRICE. I do not recall whether the percentage requirements are the same or not.

Senator DOUGLAS. I would like to ask a member of the staff to make a statement. Please identify yourself and make a statement.

Mr. TOMASULO. In the case of a foreign personal holding company the gross income test is 60 percent in the first year and 50 percent in other years.

Senator DOUGLAS. Is this the present law?

Mr. TOMASULO. Present law; yes, sir.

Senator DOUGLAS. So it is more severe in the definition of a domestic personal holding company.

Mr. TOMASULO. Yes, sir; it is.

Senator DOUGLAS. Is there any change in the bill as it comes over to us?

Mr. TOMASULO. The foreign personal holding company is not changed.

Senator DOUGLAS. What alteration is there in the present bill as regards foreign personal holding companies as compared to present law?

Mr. TOMASULO. Well, foreign personal holding company income and the foreign personal holding company tests are not changed at all on the bill.

Senator DOUGLAS. I understand the test. But what about the other features?

Mr. TOMASULO. Well, the other feature is the one you have already brought out, of course, that the basis of the stock is increased at death, and in addition, provision is made for liquidation of foreign personal holding companies in certain cases.

Senator DOUGLAS. I notice there is a statement here that there is a 1-month liquidation of foreign holding company provision. What is that?

Mr. TOMASULO. That is described at the pamphlet beginning "One-month liquidations," et cetera, immediately after what you read.

Senator DOUGLAS. Would you read it and then explain it?

Mr. TOMASULO (reading):

Section 333 of the Internal Revenue Code provides for certain special elective treatment for distributions received in a 1-month liquidation of a domestic corporation. Under that section, if the individual shareholders have properly elected, they are taxed—paragraph (1) on dividend income to the extent of their allocable share of the accumulated earnings and profits, and paragraph (2) on the capital gain realized to the extent of the amount by which the earnings and profits are exceeded by the sum of the cash in the corporation and the fair market value of stocks and securities acquired by the corporation after December 31, 1953. Except to the extent mentioned the shareholders are not taxed because of property in kind received, but such property has a basis in their hands equal to their basis for the stock surrendered, adjusted for gain recognized on the liquidation.

However, under existing law section 333 does not apply to foreign corporations.

Now, this bill provides under certain conditions that a foreign personal holding company can get section 333 benefits for a short time.

Senator DOUGLAS. What is that special benefit given by 333? It is very hard to follow these abstract statements, you know.

Mr. TOMASULO. The special benefit given by 333 is that no capital gain is recognized to the shareholder as to appreciation.

Senator DOUGLAS. It is not taxable.

Mr. TOMASULO. It is not capital under capital gains, but the ordinary income is taxed on the ordinary income just as if the corporation had distributed all its earnings and profits immediately before the liquidation.

Senator DOUGLAS. Well, now, then, to what degree can a foreign personal holding company under this bill obtain the protection of section 333?

Mr. TOMASULO. They have to elect to liquidate and liquidate within 4 calendar months, within 1 of the first 4 calendar months, ending after enactment, and in addition they must obtain the ruling of the Commissioner that there is not under section 367 of the Internal Revenue Code——

Senator DOUGLAS. I would like to ask Mr. Price if he or his firm are interested in the retention of this provision given the protective section 333.

Mr. PRICE. My senior partner, Ellsworth Alvord, is interested in that; yes, sir.

Could I point out to the Senator that these two amendments to which you have referred, applicable to foreign personal holding companies, only apply to corporations which are not only foreign personal holding companies, as the Senator has suggested in point of fact, but are also foreign personnel holding companies under the definition in the Internal Revenue Code and, consequently, have been subject to what might be called the tax penalty which applies to foreign personal holding companies.

Senator DOUGLAS. May I ask, is the definition of a foreign personal holding company that it is incorporated in a foreign country or that it derives its revenue from a foreign country?

Mr. PRICE. Incorporated.

Senator DOUGLAS. Even though it draws its revenue from within the United States.

Mr. PRICE. Regardless of the source of revenue; yes, sir.

Senator DOUGLAS. Regardless of the source.

Mr. PRICE. It has to be owned, of course, it is a foreign corporation owned by US. citizens or residents.

Senator DOUGLAS. This is a very complicated subject, one of the most complicated in the whole bill, and I certainly do not pretend to be an expert on it. I may have misunderstood the statement of our very able staff member on the subject.

As he interpreted these last paragraphs, it sounded to me as though there was a short period during which a foreign personal holding company as continuously defined, could escape from the tax on capital gains which is laid down as a general principle in the first paragraph on page 84. Am I mistaken on that?

Mr. TOMASULO. No, sir; you are correct, by being treated exactly as a domestic company by that liquidation.

Senator DOUGLAS. That raises, of course, the whole question of liquidation provisions for domestic companies which I hope we can pursue.

Mr. PRICE. Yes.

Well, I would like to make perfectly explicit the point that since the Senator has referred to the case in which Mr. Alvord is interested or has invited my reference to it, that case involves a company which is a foreign personal holding company as defined in the law on which consequently all of the income of that corporation has been taxed to the stockholder at his individual income tax rate.

Senator DOUGLAS. Is this case before the court or before the Internal Revenue Service?

Mr. PRICE. No, sir; it is neither before the courts nor before the Internal Revenue Service because there is no existing problem with respect to it.

The stockholder has paid the tax on all the income of that corporation at his individual surtax rates. The only problem is, or the problem that the bill deals with is, that the corporation does hold a substantial amount of securities which are today worth more than they were when acquired by the corporation. They have appreciated. All of the dividends and interest on those securities have always been taxed at individual surtax rates.

Senator DOUGLAS. The people at interest have a perfect right to obtain attorneys, and the attorneys have the right to represent them to the best of their ability. I am not questioning this in the slightest. I am merely trying to get the issue clear in my own mind.

Then, do I understand that this corporation, if it could take advantage of section 333, which seems to be given by later paragraphs, would be able to avoid the tax on capital gains which otherwise would be levied under the main provisions of the bill as it comes to us?

Mr. PRICE. Well, it would be able—the stockholder would be able to liquidate that corporation——

Senator DOUGLAS. Yes.

Mr. PRICE. And take direct personal ownership of the securities which are now held by the corporation.

Senator DOUGLAS. Without having to pay——

Mr. PRICE. Without having to pay capital gains tax at that time. Of course, if he later disposed of the securities he would then pay

the tax on that appreciation. In other words, that appreciation would not be tax exempt but tax deferred.

Senator DOUGLAS. I understand. That helps to clarify a very puzzling situation. Thank you very much.

Mr. PRICE. Thank you, sir.

The CHAIRMAN. Thank you, Mr. Price.

The next witness is Mr. Richard L. Goldman of the Association of Mutual Fund Plan Sponsors.

Mr. Goldman, take a seat, sir, and proceed.

STATEMENT OF RICHARD L. GOLDMAN, ON BEHALF OF ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.

Mr. GOLDMAN. Mr. Chairman, my name is Richard L. Goldman. I am an attorney, of the law firm of Ehrich, Stock, Valicenti, Leighton & Holland, in New York, and I appear today on behalf of the Association of Mutual Fund Plan Sponsors. The association is made up of sponsor underwriters, of the plans by which an investor accumulates shares of a mutual fund over a stated number of years by a program of periodic investments—for example by paying $10 a month for 10 years.

The code is already being amended in section 216 of the bill, because of new restrictions which are to apply to personal holding companies, to assure that the tax law will stay the same as to periodic investment plans and the mutual funds themselves. However, another technical amendment is needed to avoid what would, in effect, change the law as to the periodic investment plans by the overturning of an administrative tax practice of more than 23 years' standing.

The threat is, in brief, that one investor's gain from his periodic investment in a mutual fund would not only be, as at present, fully taxed to himself, but would be taxed to the other investors under the plan as well.

I will elaborate in a moment.

Let me report first that well over 1 million periodical investment plan programs are in effect today; there are probably over a million and a quarter accounts. The planholders are small investors of limited means, generally small business, professional, and skilled and semiskilled people. In the case of a representative plan, most of the people invest $25 or less a month and receive less than $50 a year in income from their investment programs. The average paid in, under a periodic investment program, approaches $2,000.

Over $2 billion is invested in mutual funds through periodic investment programs, and over $5,300 million is scheduled to be invested when the now outstanding programs are completed. Over $1 in every $5 invested in those funds which have plans is invested through a periodic investment plan. Hundreds of thousands of families are interested.

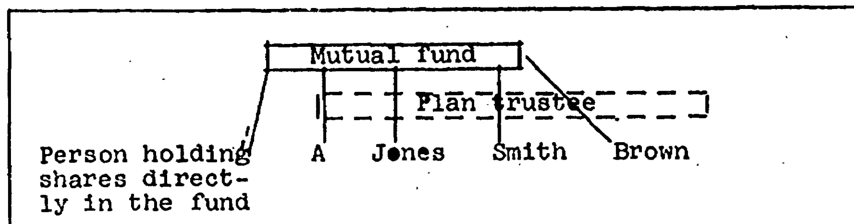
Our problem arises in this way. Suppose that 10,000 investors buy 10,000 units—1 each—in a trusteed periodic investment plan. The trustee uses the money, after authorized deductions, to buy shares in the mutual fund designated under the plan trust instrument. The fund shares rise in value, and one planholder liquidates his unit of interest in the plan at a gain.

The tax threat is that, by a novel technical construction of the law, 99.99 percent of his gain would be effectively taxed to the other 9,999 investors, even though the individual actually enjoying the gain pays a full tax on 100 percent of his gain himself.

This seems unfair.

In effect, it would undo to a large extent the so-called passthrough tax concept, which Congress provided nearly 30 years ago for the small investors. Congress permitted them by means of this passthrough concept to invest collectively through regulated investment companies, in order to obtain professional management and diversification of risk—and contemplating that the mutual fund investor would have the right to withdraw his interest at any time by redemption—without having to pay extra taxes at the corporate level. The threatened treatment would deny this opportunity to pool small resources free of corporate tax, as to hundreds of thousands of people.

The machinery of the threatened treatment can be explained briefly, by using a simple diagram and by reminding ourselves that the planholders who invest under a periodic investment plan are regarded as associating for profit in a quasi-corporate arrangement which, as a "regulated investment company," is taxed only on undistributed income, if any.



Let us suppose that four people—Messers, A, Jones, Smith, and Brown—cause $100 each to be invested in a mutual fund, through the trustee custodian of their plan. The value of each investment rises to $140, and Mr. A orders the trustee to liquidate his account by selling fund shares, equal to the number of shares in his account, back to the fund. The trustee has to return the shares to the fund for redemption, and distribute the proceeds to A.

Now, under tax law a gain will be technically realized in the amount of $40 by the plan trust, which is technically a "regulated investment company." But since the trustee is not taxable on income which is paid out, and since the trustee distributes the entire cash proceeds to Mr. A, it has always been regarded as not having any undistributed income left to be taxed; Mr. A of course has always been fully taxable. The suggestion now, however, is that a subsection of the code (sec. 562(c)) provides that a "preferential dividend" is not to be treated as distributed, so as to be free of corporate tax—this finds application today chiefly as to personal holding companies—and that because each of the four planholders does not receive a fourth of Mr. A's gain on a pro rata basis—something which is impossible under the plan, of course—Mr. A is getting a "preferential dividend": only $10 of Mr. A's gain, a one-fourth part, would be regarded as distributed

income and the rest would be treated as still undistributed and subject to corporate tax. Thus if you were Mr. Smith, Jones, or Brown, you would bear a tax through the trustee on A's gain and would find that a part of your investment had disappeared in taxes.

If, as is common, there are 10,000 people under the plan, all but one-ten thousandths of Mr. A's gain—9,999/10,000 of it—would be regarded as taxable in effect to the 9,999 investors with no interest in the gain, even though it was fully paid out and taxed to Mr. A.

The longer the planholders retained their investments, the worse off they would be—the more times they would have to bear tax on someone else's gains.

It is in these circumstances that we appear before you today.

The planholder investors and their families, most of whom pay in $25 a month or less, are unlikely to bear any understanding for such a bizarre and unfair result.

Since a mere technical distinction in the tax law would be the cause of the planholder bearing more taxes than the direct fund shareholder, planholders would lose faith in the plan program and liquidate, even at a loss, to their damage.

It may be presumed that there would be damage to the industry, to the related funds, and perhaps—by causing less money to flow into the stock market—to the market in general.

It has not been suggested that Congress ever intended to raise revenue out of these circumstances, and indeed the people who typically invest $10 or $25 a month are more likely to need to invest collectively than someone who can invest directly, with a lump sum.

The administrative practice has been to regard the situation as not giving rise to tax at the plan level, and this has been the case during the entire life—over 23 years—of the periodic investment program as it is known today. Accordingly, many thousands of people of limited means have committed their savings, without warning that they would suffer a tax as if they were in a business corporation.

It is evident that no tax was intended, or regarded by the taxing officials as intended, by Congress because of the way in which the new plans have avoided the problem. The trustee under the newer plans distributes the fund shares in kind to the liquidating planholder—technically avoiding a sale, or therefore a gain, by the plan. But the trustee does this by having the shares, until then held in the trustee's name for the planholder, reregistered in the planholder's name and then having the fund redeem the shares from the trustee as the planholder's agent.

This contrivance is immaterial to the fund, which is in any case required to accept the shares for redemption when offered. Such a series of paper transactions involving a prearranged sale would never be honored at face value by the Internal Revenue Service, in view of the substance and net effect of the steps regarded as a whole, if the Service did not accept that Congress had no intention of raising revenue in these circumstances. The very regulations of the Treasury on partial liquidations (sec. 1.346–3) alert the agents to this kind of thing.

We have suggested as much to the Treasury, and have stressed that to regard one man's gain as taxable in effect to others here is to impute to Congress a very misdirected way of taxing income; and that, even

technically, the law does not call for treating a distributed gain as undistributed, or as distributed preferentially, when the trustee is required by the governing documents to give the liquidating planholder his exact prorata share of the total value held for all the planholders collectively.

It is only in the direst emergency, therefore, that we come here. We know the burdens weighing upon this committee. We would ordinarily look to our court remedy, and be confident of obtaining it.

However, there is no court remedy here. This is an unusual case in this respect, too. A great pressure is being exerted by the Securities and Exchange Commission, which has raised the question of a tax liability—presumably due to contact with Internal Revenue—and could, for example, require that money be set aside by the plan trustee as a reserve for taxes. This would immediately reduce the net asset value payable to a planholder upon redemption.

Thus he would receive only his prorata share of a reduced figure, and this would be the same to him as if he had taken the money and mailed it to the Internal Revenue Service, for most practical purposes.

The SEC has told us to find a solution by the winter's end, when certain plan prospectuses come up for renewal, or they may not be declared effective for the following period. There is no effective court remedy for this.

It is, therefore, only by reason of being driven to the wall in this way, by the threat of a long-standing administrative practive being overturned at the instance of a nontax agency, that we are forced to come to this committee with our petition for fair handling.

The matter can easily be clarified in the bill, which already seeks to guard the regulated investment company against a change in the law. It does not touch any major policy issue, would not create public controversy, and does not threaten any revenue loss. No money would leave the Treasury by way of tax refunds, because in over 23 years none has been collected in these circumstances; it is rather to prevent a change in tax treatment that we are here.

Finally I have not heard, and I do not know any reason from the Treasury's side which would fairly be urged in opposition, so that I hope the Treasury will support our proposal, which is appended, and which I have already submitted to their extremely able and courteous Tax Legislative Counsel, Mr. Donald C. Lubick, and to the Congress through the staff of the Joint Committee on Internal Revenue Taxation.

(Proposed addition to section 562(c) of the Internal Revenue Code follows:)

This subsection shall not apply to a unit investment trust registered under the [Inv]estment Company Act of 1940, issuing periodic payment plan certificates as [def]ined in that act and qualifying to be treated as a "regulated investment company" under sections 851 through 855, with respect to taxable years ending after December 31, 1959.

Mr. GOLDMAN. We feel that if the problem can be given consideration, the committee will find a fair result for the hundreds of thousands of families involved. I thank this committee for permitting me to appear before it today.

Of course, I will be happy to answer questions, if there are any.

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

Senator Douglas?

Senator DOUGLAS. As I remarked, these are very subtle questions, and it is sometimes hard to determine precisely what the actual issues are.

Would it be unfair for me to inquire whether what you are fundamentally objecting to is the capital gains provision on securities sold and then proceeds distributed to the members of mutual investment funds?

Mr. GOLDMAN. Yes, sir; that is precisely the matter to which we object.

Senator DOUGLAS. Well, I raise this question: If an individual has to pay a capital gains tax why is it proper to shield the individual from the capital gains tax because of the fact of there having previously been a corporate shield?

Mr. GOLDMAN. Well, sir, I am not sure that I follow the question but let me say that the individual who has the gain, who has made the investment and now liquidated it, does pay a full 100 percent tax on the gain, always has and, I suppose, always will.

The question here is whether notwithstanding the passthrough concept that there should ordinarily be no second tax for the various small investors at the corporate level, that this gain being taxed to the man who liquidates is nevertheless to be taxed again to all the other people who have no interest in that gain.

It is, therefore, a tax to people who are uninterested in the money that we are raising an objection to. But we certainly have no objection to a man who makes an investment and liquidates at a profit paying a tax on it. That would hardly be other than very correct.

Senator DOUGLAS. Why would you object to a mutual investment fund paying a tax?

Mr. GOLDMAN. No, sir. What we have here are two echelons. One is the mutual fund, and then there is an entirely distinct trust entity through which people make periodic investments in the mutual fund, so that one man may be buying shares in a mutual fund directly and, of course, whatever gain he has he will pay a tax on, and any distribution received will be taxable; and another man will invest in the same mutual fund by a series of periodic investments, such as $10 a month, and also anything received from the mutual fund will be taxable to him just as to the direct fund shareholder.

The distinction which is threatened is that when the direct fund shareholder liquidates, he, of course, has a tax, and that is the end of it. But when the fund shareholder, through the periodic investment plan which is considered, as I say, a sort of quasi-corporate arrangement, when he liquidates, he will not only pay his own tax but that gain will also be taxed to the other people who have no interest and have been paying $10 a month.

We would like, therefore, in this respect that the plan investor be put on the same plane as the direct fund shareholder, and that no second tax be introduced by reason of the trustee custodian who stands between the fund and himself.

Senator DOUGLAS. I have many questions, but I find it difficult to express them. I am baffled by all the complexities of this personal holding company——

Mr. GOLDMAN. I should introduce at this point, Senator, that I am not here on behalf of the personal holding companies or of any one of them. It is only that there is a provision which affects not only the personal holding companies but also, in section 562 as it stands, the regulated investment companies, that brings me here, and it is, as I say, not by reason of any concern to speak on behalf of, or against, the personal holding companies that brings me here, but rather that those people who are investing through an entirely nonpersonal holding company in a mutual fund through a plan custodian are threatened by something which it is clear the Congress never intended in the past, and, indeed——

Senator DOUGLAS. Would you make clear just what is this double taxation which you say would exist under the bill as it is now drawn and as it came over to us from the House; just where is this double taxation?

Mr. GOLDMAN. Perhaps I have not explained as clearly as——

Senator DOUGLAS. I am probably a very stupid man on this, and if you will forgive my slowness I would appreciate it if you would make it clear.

Mr. GOLDMAN. The situation is that now under present law, as we understand it and as the Treasury has always understood it, somebody who invests in a mutual fund by reason of a periodic investment plan should not pay any tax on a gain generated by anybody else, and distributed to him in cash, because there would be—this should not be considered as undistributed income, it being paid out.

Senator DOUGLAS. How can you say it is generated by somebody else or by proportionate investment by the man under the mutual fund?

Mr. GOLDMAN. Well, the arrangement under the periodic investment plan, unlike the mutual fund as such, is that a man remits, let us say, $100 which goes net to a trustee, and the trustee is required under the instrument to invest his money in the particular mutual fund for which that plan exists and that, of course, is why he is investing it. There is no diversification by a plan trustee. The trustee is an entity which exists so that a person may invest by way of periodic investment, and shares are registered for his account in that mutual fund.

The trustee holds those shares, and at any time under the Investment Company Act of 1940, and other regulations, the individual who has, let us say, 10 shares in the fund held for his account can say, "I want my investment liquidated. Kindly sell my shares and distribute the proceeds to me."

By "sell my shares" of course I mean the trustee is to surrender them to the fund for redemption. That is in line with the open end feature which a direct investor in a mutual fund would have.

Senator DOUGLAS. Are you saying that under the proposed law that the mutual fund would pay the tax and then the individual, either himself or the trustee, would pay an added tax?

Mr. GOLDMAN. The trustee would pay an additional tax over and above everything that a mutual fund would pay.

Senator DOUGLAS. Would the mutual fund pay a tax on capital gains under the proposed law?

Mr. GOLDMAN. The mutual fund is in a somewhat different position. It is underlying——

Senator DOUGLAS. I wonder if you would be willing to answer the question. Under the proposed law would the mutual fund pay a capital gains tax on the securities which it sold?

Mr. GOLDMAN. Yes, sir. A mutual fund would pay tax on capital gains.

Senator DOUGLAS. It would; and then it would be taxed again?

Mr. GOLDMAN. Sir?

Senator DOUGLAS. And then it would be taxed again to the trustee or the individual?

Mr. GOLDMAN. Well, if it distributed the proceeds to the investors then there would be no undistributed income—am I not audible, sir? If it distributed the proceeds of capital gains a mutual fund itself would not be taxable. That is the passthrough idea.

Senator DOUGLAS. That is what I was speaking of, when it did distribute it. So the mutual fund would not be taxed.

Would the trustee or the individual be taxed?

Mr. GOLDMAN. The individual recipient certainly would be taxed.

Senator DOUGLAS. Where is that double taxation? It would be double taxation if both were taxed, but you are now saying that it is only the individual or the trustee who pays the tax. I fail to see double taxation there.

Mr. GOLDMAN. Well, sir, it is the threat that the plan trustee who is considered an interposed entity equivalent to a corporation, that the plan trustee would have to pay a second tax.

Senator DOUGLAS. Would the trustee pay the tax and then the individual pay the tax?

Mr. GOLDMAN. Yes, sir.

Senator DOUGLAS. Both of them?

Mr. GOLDMAN. Yes, sir. The individual would pay a full tax and would leave his proceeds and report a full tax. The trustee would remain, of course, holding fund shares for all of the other investors by periodic investment, but would be subject to a tax, and that would be borne by these other people.

Senator DOUGLAS. And the tax is identical?

Mr. GOLDMAN. Yes, sir; at capital gain rates at present.

Senator DOUGLAS. 25 percent?

Mr. GOLDMAN. Yes, sir.

Senator DOUGLAS. The maximum.

Mr. GOLDMAN. Yes, sir; and it would come to a disparate treatment, of course, as against the direct fund shareholders.

Senator DOUGLAS. I would like to ask the staff if this is true.

Mr. TOMASULO. Yes; that is correct. That is the proposed position of the Service.

Senator DOUGLAS. Thank you.

The CHAIRMAN. Anything further? Thank you very much, Mr. Goldman.

Mr. GOLDMAN. Thank you.

The CHAIRMAN. The next witness is Mr. James S. Mentzer of the American Finance Conference, Inc.

Mr. Mentzer, take a seat, sir, and proceed.

STATEMENT OF JAMES S. MENTZER, TREASURER, AMERICAN FINANCE CONFERENCE, INC.

Mr. MENTZER. Mr. Chairman and Senator Douglas, I am James S. Mentzer. I am connected with an independent finance company and also treasurer of the American Finance Conference, a trade association of independent time sales finance companies with some 225 member companies, principally in the United States. A company engaged in the lending or finance business must be an active business and must maintain local offices in the territories in which it operates. These offices are staffed with full-time employees to acquire new business and to collect the receivables of the company.

Some of the members of the association are large publicly held companies, however, about 35 of our smaller member companies who have in excess of 350 offices and in excess of 2,500 employees are closely held and are therefore concerned with the personal holding company tax provisions.

Historically it has been recognized that companies of this sort should never be subject to the personal holding company tax.

The four exemptions for finance companies in the present law are of a very technical nature and some confusion has existed with respect to their interpretation even among accountants and lawyers. We believe that the amendments contained in the bill represent a substantial step toward simplifying the exemption of lending and finance companies. The bill provides a single exemption and recognizes problems which arise over the fact that separate corporations are frequently required to comply with State regulatory laws for finance and loan companies.

The proposed amendment does, however, contain some limitations which undoubtedly were not foreseen at the time it was drafted. H.R. 8363 as adopted by the House contains two principal requirements which a lending or finance company must meet before it can qualify for exemption from the personal holding company tax. For convenience I will refer to these as the "60-percent test" and the "20-percent test"—

1. The 60-percent test: The bill as drafted by the House would exclude, subject to certain other limitations, a lending or finance company if 60 percent or more of the ordinary gross income of the company is derived directly from the active and regular conduct of a lending or finance business. The regulatory laws under which finance and loan companies operate frequently require separate corporations. Economy of operation, however, necessitates that many functions be consolidated in a single corporation. For example, one corporation frequently hires the necessary personnel, acquires the appropriate facilities, and in accordance with requirements of the banks and insurance companies borrows all money for the group. Arrangements are then made to make these various facilities available to the group with appropriate charges therefor. Most major companies in the business make insurance coverage available to their customers. In order to be competitive smaller companies must follow this same practice.

The bill requires that 60 percent of the company's income be derived from the lending or finance business in order to qualify for exemption, but it is not clear that income from sources such as those mentioned above would be included in making the 60-percent test. I would like to give a hypothetical illustration of a company to illustrate this problem. First, let us take a situation in which we have interest from lending or finance business constituting 59 percent of the total income of the company; secondly, service to affiliated finance company 30 percent, and insurance income from lending or finance business 7 percent, and rental income of 4 percent, making up a total of 100 percent income of the company.

It will be noted that the interest and rental income combined equal 63 percent of total income and, therefore, 60 percent of the company's income is personal holding income. The company must, therefore, rely on the exemption section. If interest is the only part of the company's income which would be considered as being derived from the active conduct of a lending or finance business, the company would not meet the 60-percent test and would not qualify for the exemption We suggest that proposed code section 542(d)(1)(A) be amended as follows—I might simply state that we propose to add two items of income which would make it appear that all income from business, from the finance business, including income from other companies in the group would be included in making the 60-percent test:

[New language is in italic, language which would be eliminated is enclosed in black brackets]

(A) IN GENERAL.—Except as provided in subparagraph (B), for purposes of subsection (c)(6), the term "lending or finance business" means a business of—

(i) making loans, or

(ii) purchasing or discounting accounts receivable, notes, or installment obligations,

(iii) rendering services or making facilities available to another member of the same affiliated group (as defined in sec. 1504) that is also in the lending or finance business, or

(iv) earning income from activities related to those described in clauses (i), (ii), or (iii).

The second point with which we are concerned is the so-called 20-percent test. Under the bill, a company would not qualify for exemption if 20 percent or more of its income was of a personal holding company nature and was not derived from the lending or finance business. This seems inequitable since it limits finance companies to 20 percent unrelated income, whereas manufacturing, retail, and other similar businesses can have 59 percent unrelated income. Therefore, we believe the 20-percent test should be dropped.

In the event that this position is not adopted by your committee, however, the kinds of income which are to be excluded in making the 20-percent test must be carefully defined. Otherwise, a perfectly legitimate, actively operated lending or finance company could be subject to personal holding company tax.

The bill as it presently stands is, we believe, unduly restrictive and creates a result which was not intended. It would permit a company engaged in the small loan business, in making the 20-percent test, to exclude income which it receives from subsidiaries in the lending or finance business.

In many cases, however, the parent companies are engaged only in the retail finance business, the business of making commercial loans, factoring, or similar activities. We believe that any lending or finance company in making the 20-percent test should be able to exclude income from all affiliates which are also engaged in the lending or finance business.

In response to an inquiry to the 35 interested companies of our group, 16 indicated that their parent was not engaged in the small loan business. These companies could not meet the requirements of code section 542(c) (6) as contained in the bill without reorganization of their affairs.

A second problem in connection with the 20-percent test is that under proposed code section 542(d) (3) the subsidiaries must be "themselves excepted under subsection (c) (6)." This creates an ambiguity since certain subsidiaries are currently excepted under the doctrine in the case of *Elk Discount Corporation* (4 TC 196 (1945), acq. 1944 CB 9) and it is therefore not clear whether they would be excepted under section 542(c) (6) or under section 542(a) (1).

Both of the above problems can be solved by changing proposed code section 542(d) (3) as follows—the effect of the change is to make clear that the income from other companies in the group is not to be included in making, is not a part of the 20 percent in making, the test to see whether the company can qualify for the exemption:

[New language is in italic, language which would be eliminated is enclosed in black brackets]

(3) INCOME RECEIVED FROM CERTAIN DOMESTIC [SUBSIDIARIES] CORPORATIONS.—For purposes of subsection (c) (6) (B), in the case of a lending *or finance* company [which is authorized to engage in and is actively and regularly engaged in the small loan business (consumer finance business) under one or more State statutes providing for the direct regulation of such business, and] which meets the requirements of subsection (c) (6) (A), there shall not be treated as personal holding company income the lawful income received from domestic [subsidiary] corporations [(of which stock possessing at least 80 percent of the voting power of all classes of stock and of which at least 80 percent of each class of nonvoting stock is owned directly by such lending company)] *which are members of the same affiliated group (as defined in section 1504)* which [are] themselves [excepted under] *meet the requirements of* subsection (c) (6).

The lending or finance companies which are affected by the personal holding company law are smaller companies competing with large chains and if these companies are to continue operating in this field they must have effective relief which will enable them to operate their businesses in much the same manner as their large competitors.

The personal holding company tax law exemption for finance companies as contained in the bill modified as suggested herein would, if the Treasury continues to acquiesce in *Elk Discount Corporation*, give adequate safeguards for the revenue and would still allow smaller companies to effectively compete in this industry. We urge that these amendments be adopted.

Thank you, Mr. Chairman and Senator Douglas, for this opportunity to present this statement to you. I would be glad to attempt to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Mentzer.

Senator Douglas, any questions?

Senator DOUGLAS. No questions.

The CHAIRMAN. Thank you very much, sir.

The next witness is Mr. Thomas Meek of the National Association of Investors' Brokers.

Take a seat, Mr. Meek, and proceed.

STATEMENT OF THOMAS B. MEEK, CHAIRMAN OF THE NATIONAL ASSOCIATION OF INVESTORS' BROKERS

Mr. MEEK. Mr. Chairman and Senator Douglas, I appreciate the opportunity of testifying on sections of the proposed tax legislation relating to capital gains and losses and their effects on the actions of investors.

My name is Thomas B. Meek. I am chairman of the National Association of Investors' Brokers which has affiliate associations in New York, Chicago, and Washington. I am a branch manager for Harris, Upham & Co. in New York and have been in the securities business since 1922. With me are Mr. Ralph M. Newman, president of the Washington Association of Customers' Brokers and Mr. Charles Redick, chairman of its committee on legislation. Both of these gentlemen are associated with Jones, Kreeger & Co. in Washington.

The associations I represent are composed of registered representatives, or customers' brokers, employed by member firms of registered stock exchanges, members who become partners are continued as associate members.

Our associations are voluntary and self-supporting, with professional ideals and goals. The first one was started in New York in 1939 with the primary objective: "To preserve and inculcate the highest standards of business conduct in our profession and to sponsor measures deemed in the interest of the investing public."

We have urged higher standards of education and competence for those advising and serving the public directly in securities transactions. We wrote the first code of ethics in Wall Street and have inaugurated and conducted educational forums.

The views of our associations may or may not agree with the views of the brokerage houses and stock exchanges. Since we registered representatives are in day-to-day contact with customers, any inequity or dissatisfaction comes to our attention promptly. Our viewpoint therefore, reflects what our clients are saying and doing and this statement to you is in a large measure a report on the reactions of the investing public.

I will not present detailed tables on this subject, because the Treasury, the staff of the joint committee, and the New York Stock Exchange have done an excellent job in this respect. Our findings are based on surveys of our members and meetings and conversations with registered representatives in every principal city of our country.

In our discussions the capital gains and loss provisions of our tax laws have dominated the floor on many occasions. A survey revealed the opinion that 75 percent of our customers' investment decisions to sell were influenced and inhibited by tax considerations rather than analysis of values. The influence on buying decisions was obviously

less. I would like to quote two paragraphs from a leaflet prepared by our association in 1954:

The capital gains tax and holding period act as roadblocks—

1. To people who could supply new capital through the purchase of securities, but do not do so. Either the 6 months' period looms as too long a period to forecast the future, or the rate of tax is a deterrent. These people prefer to keep their funds in relatively static holdings, such as tax-exempt bonds or cash. As a result, the Federal and State Governments lose potential tax revenues and new tools and new job opportunities are lost to the Nation.

2. To people who own securities, but are restrained in the exercise of sound judgment about the sale of overvalued shares, either for the purposes of later reinvestment in the same issue or for substituting a more advantageous investment. Ironically, the greater the increase in the value of a security, the greater the reluctance to dispose of it. It is here the investor calculates how much a new investment would have to gain in dividends and in price to compensate for the amount that the tax subtracts from his capital * * *. Again, the Government loses potential tax revenues.

It is a peculiar quirk about human nature in money matters, that if you ask a man if he were to make $10,000 on a security held for 6 months and a day, would he be willing to pay the Government $2,500 in taxes, he immediately says "Yes." But if he has a profit of $10,000 on a security he has held for more than a year, he then feels he is worth $10,000 more, not $7,500 and is usually reluctant to sell because of the tax involved.

Because we believed the existing taxes on capital gains, handicap intelligent investment decisions, freeze and restrict much-needed capital formation, and reduce potential Government revenues, a group of our members came to Washington in the early 1950's to present our views individually to members of your committee and the House Ways and Means Committee. We recommended at that time and still do, a reduction in the rate of 12½ percent, and shortening of the holding period to 3 months. By a survey we arrived at an estimate that $250 million for tax revenues had been lost in 1950 and $200 million in 1963. A more scientific survey of investor intentions for the year 1960 has been conducted by Louis Harris & Associates for the New York Stock Exchange. I repeat their two conclusions because they confirmed our estimates and opinions. The Harris survey indicated taxes from capital gains in 1960 would have more than doubled, or a gain of $1.5 billion and five times as much capital, or $25 billion additional, would have been unlocked for investment.

Our members and our clients were considerably encouraged this year by a statement in the late President Kennedy's tax message. I would like to insert it again in your record because it expresses so well our thinking over many years. [Reads:]

The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dunamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for the growth of the economy.

A big forward step has been taken in the reductions in captial gains taxes in H.R. 8363 and we endorse it thoroughly. I wish to point out that the gains in revenues and stimulus to the economy may not be as great as they might have been. As you are aware, the percentage reductions in the taxable income brackets up to $26,000 average about 30 percent and then drop abruptly to 16 percent for brackets $26,000 and upward. We favor encouraging the smaller investor, but

analysis of Treasury reports of tax returns would indicate the greatest amount of capital formation and the greaest amount of locked-in and unproductive capital may be expected to exist in the higher brackets.

Two additional observations about the effects of capital gains taxes: First, by discouraging investors from taking profits the supply of many stocks is diminished, resulting frequently in unusually sharp fluctuations, and overvaluations. Second, the longer the holding period, the less tendency there is to be involved in investment risks. A questionnaire sent to our members this year indicated investment transactions would be reduced 30 percent if the holding period were extended to 1 year.

We also wish to repeat that our country is the only major country that imposes capital gain taxes. This comes as a shock to investors who believe ours is the leading country in encouraging the flow of capital. As you and I know this has not been true in our more recent history.

We are pleased that the House has taken an initial step in correcting some of the inequities in the carryover of losses; and Mr. Ralph Newman will speak to you briefly about that in just a moment.

It is commendable, we believe, that the House did not include the administration's proposal to tax capital gains at death in its final bill. Aside from the legality and equity of such a measure, it would not accomplish as much benefit to the economy as would lower rates for capital gains. These would release capital for more productive uses and start earlier and continue over a period of years.

In addition to the capital gains sections of H.R. 8363 we are vitally concerned about the dividend exclusion and credit features of the bill. The proposed elimination of the dividend tax credit would make stock ownership less attractive and hardly seems consistent with the avowed purpose of the tax message to promote economic growth through more flexible and dynamic investment. The entire principle of double taxation of dividends seems inequitable particularly since most major free enterprise nations grant greater relief from dividend tax imposition than the United States.

It has been stated that the dividend credit favors the wealthy. However, our members report the greatest number of complaints against the change in the dividend credit has come from the smaller investors. They are favored according to the percentages of the tables, but dividend earnings no matter how small, usually mean additional purchasing power for these people. The larger investor frequently puts his dividend income into other investment. If this net return becomes unattractive, he can put his money into tax exempts. The detriment to the economy seems apparent.

The phenomenal increase in number of stockholders in our country from 6.5 million in 1952 to 17 million in 1962 has been due in part to the more favorable treatment of dividend income which was enacted in 1954. The greater the number of stockholders the broader is the foundation for capital formation. We believe that reduction or elimination of the dividend credit will reverse a favorable trend.

To summarize:

We commend the more liberal treatment of capital gains in H.R. 8363. We suggest your consideration of a reduction in the capital gains tax rate to 12½ percent and the holding period to 3 months.

We endorse the elimination of any time limit on loss carryover as provided in H.R. 8363 but suggest increasing the $1,000 permissible annual deduction which Mr. Newman will discuss.

We favor the restoration of the 4-percent tax credit on dividend exclusion in H.R. 8363. For the longer view we favor a 10-percent dividend tax credit, believing it would further encourage ownership of equities. I wish to add there we also favor the inclusion of the $100 dividend credit.

In conclusion, may I praise your committee for its thorough consideration of this tax legislation in the light of our country's fiscal responsibilities.

The administration and the Congress will, in our opinion, be providing a long-needed stimulus to our country's growth if a revenue measure that results in adequate net tax reduction can be written and passed.

In the forward step you are taking, we urge your consideration of an equally forward-looking step to give capital gains and losses more favorable treatment. We would not suggest this if we did not sincerely believe reductions of capital gains could result in greater stimulus to the economy and immediately higher tax revenues. And we say this without regard to the interests of our own profession, except that we hope to serve our clients better. I might add we are somewhat in the position of the medical profession, which it might be if there was a heavy tax on operations. We quite often would want to operate to save a patient's or a client's financial life, but we are unable to do so because of financial costs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Meek.

(At the request of Senator McCarthy the following is made a part of the record:)

THE SECRETARY OF THE TREASURY,
Washington, November 18, 1963.

Hon. EUGENE J. MCCARTHY,
U.S. Senate, Washington, D.C.

DEAR GENE: This is in response to your request of November 1 for a clarification of the possible effect of the proposed changes in the personal holding company provisions of the Internal Revenue Code under section 216 of H.R. 8363 on the interpretation of the term "interest" as it is used in paragraph (1) of section 543(a) of existing law. Specifically, you have asked whether the Treasury will consider "interest" to include income arising from the purchase or discount of obligations and whether the Treasury still intends to follow the precedent of the *Elk Discount Corp.* case.

The report of the House Ways and Means Committee states that section 216 of H.R. 8363 "contains no substantive change from paragraph (1) of the existing section 543(a)." (H. Rept. 749, p. A93.) Thus, the Treasury would take the position that the term "interest" in this context has the same meaning which is ascribed to it under existing law. For many years Treasury regulations under this paragraph of section 543(a) have defined interest as "any amounts, includable in gross income, for the use of money loaned." No changes in this interpretative definition will be required by the enactment of section 216 of H.R. 8363.

Several years ago, the Internal Revenue Service raised the issue whether income arising from the purchase or discount of accounts receivable, notes, or installment obligations should be regarded as interest. The leading cases on this point are *Elk Discount Corp.* (4 T.C. 196 (1944)), and *Southeastern Finance Co.*

[illegible] 1060 (1961), both of which were decided by the Tax Court. In Six Discount the court held that the acquisition of conditional sales contracts by the taxpayer from automobile dealers for prices below the face amounts of the notes acquired in connection with the contracts [illegible] did not give rise to "interest" income when the taxpayer held the notes to maturity. However, in [illegible], the same court held on substantially similar facts that the taxpayer had made loans giving rise to "interest" income because it made only partial payment to sellers of installment notes at the time of acquisition, deferring the final payment until such time as the notes had been paid in full by the obligors. In distinguishing the different results in these two cases, the Tax Court noted that "where part of the amounts paid for accounts or papers is to be paid only after such accounts or papers are collected, such factor is a vital one in determining whether the transaction constituted a loan or a sale * * *" (34 T.C. 1060, 1068). The distinction made by the Tax Court in these two cases has been acknowledged by the Internal Revenue Service for many years and the Service presently has outstanding a published acquiescence in the [illegible] of the Six Discount Corp. case (1962 C.B. 5). The enactment of section 210 of H.R. 8363 will not require a withdrawal of this acquiescence by the Service.

With best wishes,

Sincerely,

DOUGLAS DILLON.

The CHAIRMAN. Proceed, Mr. Newman.

STATEMENT OF RALPH NEWMAN, PRESIDENT OF THE ASSOCIATION OF CUSTOMERS' BROKERS, WASHINGTON, D.C.

Mr. NEWMAN. Mr. Chairman and Senator Douglas, I have given special attention to section 1211(b) of the Internal Revenue Code and its capital losses to $1,000 in any one year in the absence of capital gains; and to section 1212 of the Internal Revenue Code which provides that capital losses may be carried forward for 5 years; and the House bill, H.R. 8363, extends the 5-year period to an unlimited period of time.

Section 1211(b) of the code should be amended primarily because it brings about an inequity and a double standard of taxation for profits and losses. Perhaps this can be illustrated best by example. Even though an individual taxpayer may have reported capital gains of $10,000 from the sale of securities in 1962, if he should sustain capital losses of the same amount in 1963, he would be permitted to deduct only $1,000 of his loss in 1963.

In addition, this individual would be required to report and pay taxes on all dividends received in 1963, even though the dividends may have been derived from the stock which he sold at a loss, the remaining $9,000 in capital losses would be postponed for future use, and in the absence of capital gains the last of these losses would be recovered 9 years later under the House bill.

The immediate collection of income taxes on capital gains and dividends, when coupled with the postponement of capital losses to future years, deprives the investor of the use of his funds if he sustains a capital loss.

To carry forward nine-tenths of a $10,000 capital loss to future years results in a cost of $2,700 in interest when figured at the rate of 6 percent under the House bill.

H.R. 8363 would require that capital losses be carried forward to future years if these losses exceed 5 percent of a $20,000 investment, of 2 percent to a $50,000 investment, or 1 percent of a $100,000 investment. The maximum dollar investment that one could afford under

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these restrictions would be very limited. Yet, it is ordinarily assumed that there should be some reasonable relationship between the opportunity for profit and the risk of loss in any given transaction.

The risk is now such that there is a tendency to invest in high quality stocks which involve the least risk. It has become increasingly difficult to raise equity capital for smaller companies.

I urge this committee to give consideration to increasing the $1,000 limit imposed under section 1211(b) of the Internal Revenue Code to not less than $10,000. This would remove an existing inequity, encourage investment, promote industrial expansion among smaller companies, and thereby increase employment.

I would like to add, with the permission of the chairman, some information we have received from the Department of the Treasury that estimated that, in 1960, $800 million of carryover losses expired because they had not been offset against capital gains or income during the preceding 5 years. Further studies lead the Treasury to estimate about $200 to $400 million expire each year for this reason.

I would like to take this opportunity to thank the chairman and Senator Douglas for receiving us here this morning.

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

Senator Douglas?

Senator DOUGLAS. Mr. Meek, in previous discussions before this committee it has been stated that there has been such great increase in the number of stockholders in our country that now the overwhelming proportion of the stock in corporations is owned by those with low incomes and that they, therefore, receive the major portion of the dividends and that, consequently, the repeal of the 4-percent dividend credit would fall most heavily on the lower income groups. Is that your position?

Mr. MEEK. No. We feel that the dividend exclusion should be retained because it is an equitable procedure. Actually as to whether—my recollection of the Treasury's figures, if they are correct, is that about a third of the entire stockholdings are now in the hands of the top brackets, running down to about the $12,000 income level. Maybe the members of the staff can give us the exact figures on that.

Senator DOUGLAS. I see you have studied the report submitted by the Secretary of the Treasury which is printed on page 288 of the House hearings. I wonder if a copy of the first volume could be given to Mr. Meek? I am referring to page 288. It is listed as table 10 in the exhibits submitted by the Secretary of the Treasury under his testimony of February 6 of this year.

You will notice that the figures there—I will invite your attention to the percentage breakdown—indicate that though 51 percent of those who receive dividends have incomes under $10,000 a year, they received only 20 percent of the dividends, and that, on the contrary, 1.8 percent of the recipients of dividends are stockholders with incomes over $50,000 a year, and they receive 20 percent of the dividends.

So that the reception of almost one-third of the dividends is in the hands of those with taxable incomes, frequently stated real incomes, of over $50,000 a year.

Mr. MEEK. That is right. Will not the 4-percent dividend credit also help those with lower incomes even though——

Senator DOUGLAS. Yes. But the point is that it naturally will help those with the greater incomes all the more.

Mr. MEEK. Yes.

Senator DOUGLAS. I wanted to get that as an agreed basis because in times past, I remembered Senator Humphrey saying that since low-income people owned American corporations they would receive the major share of the benefits of the dividend credit.

Mr. MEEK. Well, except for people who, wealthy people who, are living entirely on dividends, we do not get much complaint from other——

Senator DOUGLAS. You deal with recipients of dividends.

Mr. MEEK. Now, the person living entirely on dividends, like a widow, will be hurt by this change in the credit. But a businessman has other offsets, so it has not had as much effect on him.

Senator DOUGLAS. Well, I will remark that widows and orphans are frequently brought in to justify provisions.

Mr. MEEK. That is right.

Senator DOUGLAS. You want to reduce the capital gains tax to 12½ percent?

Mr. MEEK. Yes, sir.

Senator DOUGLAS. And the holding period to 3 months.

Mr. MEEK. Yes, sir.

Senator DOUGLAS. Would this mean you would have a capital gains tax and not an income tax on chickens? I do not know whether eggs would come under this or not.

Mr. MEEK. Is it possible that we can confine certain sections of the capital gains provisions to securities and other sections to other commodities and businesses? I think there should be a differentiation made.

Senator DOUGLAS. In other words, you go in and out of the stock market for brief periods of time, make large amounts that you realize would not be taxed as income but only as capital gains, only one-eighth, the maximum is one-eighth, even though you might be subject to a 50-percent tax so far as income is concerned?

Mr. MEEK. That is right.

Senator DOUGLAS. Does it not put a premium on the stock speculator or the stock operators? It would lead, of course, to great activity in the stock market, and I hope you will forgive me if I say in increased commissions for brokers. But do you think this income should be really shielded from taxation?

Mr. MEEK. Well, I think the studies of the stock exchange show that most of the so-called in-and-out traders complete their transactions within a 30-day period.

Now, when a man—then, to take the next step up, consider what we call the speculator for value who takes a position in a security because he feels that it is worth more, and sometimes that realization or, quite frequently, in fact, comes about sooner than he expected. I have seen cases where securities doubled in value in less than 6 months, and then would lose the entire gain before the 6-month period was up. That even happened to such a staid security as Standard Oil of New Jersey. I think it was in 1952 that that happened, and a great many people who were long-term investors, who had bought it as a long-term investment, would have properly sold it because it was definitely overvalued, within a 6-month period.

Of course, the Treasury would gain more revenues by this accelerated turnover, and the brokers would gain more commissions, I grant that. But the reason, I will say as I said in all sincerity—that is not our primary consideration because I think most of us who have been in the business any length of time have learned that if you preserve the client's capital, the commissions take care of themselves, and if he makes money the commissions over a long period of time will multiply. So it is not the profit that is to be made by the broker.

Senator DOUGLAS. Of course, one of the problems is the way in which the law disguises income as a capital gain, and the capital gain is subject to one-half the rate of taxation of income and also subject to a maximum rate of 25 percent.

Now, if you lower this to 12½ percent and shorten the period to 3 months, I think you are going to enable a lot of what is really income to be taxed at a very much lower rate.

Mr. MEEK. That is correct.

Senator DOUGLAS. Thank you.

Mr. MEEK. I would add that in our discussions the reduction of the rate to 12½ percent has priority over the shortening of the holding period. But we have seen many injustices come about because a man could not realize his profit until after 6 months had transpired. I am not talking about the short-term trader; I am talking about the legitimate speculator for value.

The CHAIRMAN. Thank you, Mr. Meek, Mr. Newman, and Mr. Redick.

The next witness is Mr. J. T. Schlenger of the Broseco Corp.

Take a seat, sir, and proceed.

STATEMENT OF JACQUES T. SCHLENGER, REPRESENTING BROSECO CORP.

Mr. SCHLENGER. Mr. Chairman, my name is Jacques T. Schlenger, a lawyer from Baltimore, of the firm of Venable, Baetjer & Howard.

I reluctantly, perhaps, am going to plunge into the morass, as I think Senator Douglas did or meant to describe it before, of the personal holding company.

I appear here today on behalf of Broseco Corp., a Maryland corporation with its principal office in Baltimore, Md.

As you know, the revenue bill of 1963 abandons gross income and substitutes adjusted ordinary gross income as the base against which personal holding company income is measured to determine whether there is enough personal holding company income tax. The proposed change in percentage which has been previously alluded to, from 80 to 60 percent, is not opposed directly or indirectly in this statement.

However, in defining this new base, ordinary adjusted gross income, section 216(d) of the revenue bill of 1963 would amend the Internal Revenue Code so that "from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for (i) exhaustion, wear and tear, obsolescence, amortization, and depletion, (ii) property and severance taxes, (iii) interest, and (iv) rent," and then, paraphrasing the proposed bill, all in accordance with regulations to be promulgated by the Secretary of the Treasury.

The effect of such subtractions from the gross income from working interests, and I emphasize this, in an oil or gas well is to reduce the corporation's adjusted ordinary gross income and, therefore, the base against which personal holding company income is measured to determine personal holding company status.

Technically, gross income from such working interests is not classified as passive or personal holding company income and, therefore, the numerator of our fraction in determining whether the 60-percent test is met is unchanged. Again, I emphasize technically because the impact on the corporation of a downward adjustment in the adjusted ordinary gross income which reduces the denominator in such fraction is, however, equally adverse in determining the applicability of the personal holding company tax.

The late President's message to Congress spoke of royalties, not working interest gross income, as, and I quote, "a shield for dividend income."

The Treasury Department has made the proposals dealing with working interests in oil and gas wells. Judging by the example submitted both to this committee and to the Committee on Ways and Means, the Secretary of the Treasury had an entirely different situation in mind in proffering this particular proposal because he was concerned where a producing well can be purchased at a price based upon, and I am quoting, "the highly predictable oil yield in the well." He continues:

> As the oil is produced, cost depletion is taken and although the net income is small, the gross income is very large. Since the oil income is treated as operating income, each dollar of oil gross income can, under existing law, shelter almost $4 of gross personal holding company income.

The Secretary went on to say that under the new bill if he just dropped the 80 to 60 percent, almost $1.50 would be sheltered. We agree these are abuses when you purchase interests this way, and it is a matter of common knowledge, I think, in the oil and gas industry that, particularly here in the East, wealthy individuals have been asked to do just what, and what they do is that they buy a package of already existing producing oil and gas interests, and place them in a controlled corporation, along with dividend-producing stocks, and they shelter income.

The trouble in our opinion, is that the language of the revenue bill of 1963 is so broad, or loose, that it not only curbs this admitted abuse but also embraces situations falling outside of the express intent. One such situation is that of Broseco Corp.

I understand that since I have submitted this statement that there may be a few other corporations in the United States which will be adversely affected by this bill, although I think there are some factual distinctions. But I wanted to make that clear.

Now, Broseco was organized in 1936, with one individual contributing to its initial capital a substantial amount of stock in publicly held corporations. Through 1953, because almost all of its income was from dividends, Broseco admitted that it was, and was taxed as, a personal holding company.

In the late 1940's Broseco decided to go into the oil and gas business, and began doing so in a deliberate, prudent, businesslike way. Broseco has become so active in the search for, and development of,

oil and gas that it has not been a personal holding company since 1954. Broseco has spent approximately in excess of $10 million of its own money in capital outlays in exploring for, and developing working interests in, oil and gas, so that at the present time its total estimated value of its oil properties is in excess of $15 million.

During the year 1962, Broseco drilled 29.9 net wells which, we gather, puts it within the top 60 oil companies in the whole United States.

Senator DOUGLAS. How many wells was this?

Mr. SCHLENGER. 29.7, sir; these are net wells.

They participated in drilling about 75 gross wells. You net the fractional interest in the well, and you come up with 29.7 net.

Senator DOUGLAS. Is this annually?

Mr. SCHLENGER. Yes, sir; in 1962.

Now, this would put Broseco in the top 60 oil companies. From 1961 to date 85 percent of the wells drilled by Broseco have been wildcat wells, as distinguished from development wells. From its organization to date, Broseco has retained substantially its initial contributed securities and has not made substantial additions.

This factual description reveals a corporation consistently and prudently increasing its exploratory activities for oil and gas until in 1962 its oil and gas sales exceeded $1,600,000. Broseco does not purchase working interests in oil and gas wells, as in the above cases which are of concern to the Treasury Department. It develops its own oil and gas interests. It risks its own funds in wildcatting, and it has its own funds to develop its own oil and gas properties.

On this very factual basis, it is submitted that the proposed language of the revenue bill of 1963 is too broad because it would make Broseco and, perhaps, if there are any other corporations like it, a personal holding company for tax purposes. To the best of our knowledge—I had this in my statement and I will reiterate it—no other corporation in this country so deeply committed to such a great extent in the active exploration for oil and gas as Broseco would be covered by the proposed change in the personal holding company provisions.

It is difficult to conceive of policy justifications for treating an active, operating oil company such as Broseco, differently from another company solely on the basis of the number of stockholders. Should there be concern about the retention of security-type income, this can be covered under the unreasonable accumulation provisions of section 531. Parenthetically I would like to note that Broseco has paid very substantial dividends recently to its stockholders who are in the high brackets.

We do not expect special treatment. It is quite the reverse. We do not want to be singled out. I have submitted some language in the statement which would carry through the intention, the gist of which would take care of Broseco, by excluding from the bill other than acquired producing working interests. This would mean that if a corporation like Broseco develops, through wildcatting its own oil and gas interests, this gross income would not be reduced by depletion, depreciation, and other things; it would be treated exactly like any publicly held oil company.

On the other hand, if there are corporations, such as we hear about, which buy packaged producing oil and gas interests without explor-

ing for them and bearing the risk of this, they would be covered by the bill, and the Treasury should then be satisfied, and so should we.

However, if the committee, in its wisdom, decides not to do this, we would at least request a deferral until January 1, 1966, so that this would give us time to comply with the new bill. This would not permanently curb the Treasury proposal, and would be consistent with 0/2 year deferrals in the bill now because, as the Senator mentioned a little bit ago, there is a 2-year availability for this 30-day liquidation, and we ask the same sort of deferral.

I want to thank you for this opportunity to present our views and, if there are any questions, I would be happy to answer them.

(Mr. Schlenger's prepared statement follows:)

STATEMENT OF JACQUES T. SCHLENGER OF BROSECO CORP. ON SECTION 216(d) OF THE REVENUE BILL OF 1963 DEALING WITH THE DEFINITION OF OIL AND GAS WORKING INTEREST GROSS INCOME FOR PERSONAL HOLDING COMPANY TAX PURPOSES

The revenue bill of 1963 abandons gross income, and substitutes adjusted ordinary gross income, as the base against which personal holding company income is measured to determine whether there is enough personal holding company income—60 percent—to subject a corporation to the personal holding company tax. The proposed change in percentage—from 80 to 60 percent—is not opposed.

In defining this new base—ordinary adjusted gross income, section 216(d) of the revenue bill of 1963, would amend section 543(b) of the Internal Revenue Code so that "from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for—

"(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

"(ii) property and severance taxes,

"(iii) interest, and

"(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income from royalties or such gross income from working interests in oil or gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interest."

The effect of such subtractions from the gross income from working interests in an oil or gas well is to reduce the corporation's adjusted ordinary gross income and, therefore, the base against which personal holding company income is measured to determine personal holding company status. Technically, gross income from such working interests is not classified as passive or personal holding company income and, therefore, the numerator of the fraction in determining whether the 60-percent test is met is unchanged. The impact on the corporation of a downward adjustment in the adjusted ordinary gross income which reduces the denominator in such fraction is, however, equally adverse in determining the applicability of the personal holding company tax.

The President's message to Congress of January 24, 1963, spoke of royalties, not working interest gross income, as "a shield for dividend income." The Treasury Department has made the proposals dealing with working interests in oil and gas wells. Judging by the example submitted to this committee (hearings before the Committee on Finance, U.S. Senate, 88th Cong., 1st sess., on H.R. 8363, pt. 1, p. 191) and the statement submitted to the Committee on Ways and Means of the House of Representatives on February 6, 1962, the Secretary of the Treasury, in proffering this particular proposal, was concerned about situations where "a producing well can be purchased at a price based upon the highly predictable oil yield in the well. As the oil is produced, cost depletion is taken and although the net income is small, the gross income is very large. Since the oil income is treated as operating income, each dollar of oil gross income can, under existing law, shelter almost four dollars of gross personal

holding company income. Even if the 80-percent test of section 542(a)(1) is reduced to 60 percent, each dollar of oil income would shelter almost $1½ of personal holding income."

The Treasury has proper cause for concern about such abuses. It is a matter of common knowledge that some wealthy individuals have been advised to purchase, through a controlled corporation, a package of producing oil and gas interests, with highly predictable yields, in order to save substantial income taxes on dividend producing stocks held by such corporation.

The trouble is that the language of the revenue bill of 1963 is so broad, or loose, that it not only curbs this admitted abuse but also embraces situations falling outside of the expressed intent. One such situation is that of Broseco Corp., which, as the facts will show, does not involve any such tax abuse.

Broseco was organized in 1936, with one individual contributing to its initial capital a substantial amount of stock in publicly held corporations. Through 1954, Broseco was taxed as a personal holding company.

In the late 1940's, Broseco decided to go into the oil and gas business, and began doing so in a deliberate, prudent manner. Broseco has become so active in the search for, and development of, oil and gas, that it has not been a personal holding company since 1954. Broseco has expended approximately $10 million in exploring for, and developing, working interests in oil and gas.

At the present time, Broseco has developed its own oil and gas properties with a total estimated value of $15 million. During the year 1962, Broseco drilled 29.7 net wells, which, on the basis of available statistics, puts it within the top 60 oil companies in the industry. Since January 1, 1961, approximately 85 percent of the wells drilled by Broseco have been wildcats, as distinguished from development wells. From its organization to date, Broseco has retained substantially its initial contributed securities and has not made substantial additions.

This factual description reveals a corporation consistently, and prudently, increasing its exploratory activities for oil and gas, until in 1962 its oil and gas sales exceeded $1,600,000. Broseco does not purchase working interests in oil and gas wells, as in the above cases which are of concern to the Treasury Department. It develops its own oil and gas interests. It risks its own funds in wildcatting, and it has its own funds to develop its oil and gas properties.

On this very factual basis, it is submitted that the proposed language of the revenue bill of 1963 is too broad because it would make Broseco a personal holding company for tax purposes. To the best of its knowledge, Broseco knows of no other company so heavily engaged in the active exploration for oil and gas which will be similarly treated.

It is difficult to conceive of policy justifications for treating an active, operating oil company such as Broseco differently than another operating company, solely on the basis of number of stockholders. Should there be concern about the retention of security type income in excess of reasonable business needs, this can be best dealt with on a factual rather than automatic basis under the provisions of section 531 et seq. of the Internal Revenue Code. Parenthetically, the fact of Broseco's having paid substantial recent dividends to its individual stockholders should be noted.

Broseco is not seeking special tax treatment. The situation is quite the reverse, for, under the revenue bill of 1963, it alone, among large operating oil and gas companies, would be singled out for special, and undeserved, tax treatment. Should Congress, in its wisdom and judgment, decide to modify or eliminate certain tax provisions for all who are engaged in the oil and gas industry, such as percentage depletion, this would have the merit, in terms of good tax policy and administration, of being uniform in application and burden.

It is respectfully suggested that the language of the revenue bill of 1963 can be revised so as to eliminate the abuses of concern to the Treasury Department without also treating unequally Broseco. Suggested revisions are attached hereto as appendix I. The gist of the suggested revisions is to distinguish between the abusive purchase of working interests and the inoffensive development of one's own working interests. If it were desired to limit further the developed working interests so excepted from personal holding company treatment to those attributable to wildcatting as defined in the statute, this could be done. A precedent for this very type of distinction in drafting is contained in the revenue bill of 1963, where, for personal holding company purposes, "produced film rentals" are specially defined and treated.

In the event that this committee does not accept the previously submitted drafting revisions, it is respectfully requested that the provisions of the revenue bill of 1963 dealing with working interests in oil and gas wells, at least to the extent not purchased, not apply to any such interests developed before January 1, 1966. This would both immediately curb the pinpointed abuse situations and give Broseco a reasonable opportunity, in accordance with its expanding oil and gas program, to comply with the new personal holding company provisions. A limited deferral of this kind would be consistent with the provision in the revenue bill of 1963, dealing with personal holding companies, allowing the same period of time for 30-day liquidations under section 333 of the Internal Revenue Code. The 30-day (or "would have been") liquidation "relief" provision is not a satisfactory solution for Broseco because it does not want to liquidate but desires to continue its accelerating oil and gas operating program.

APPENDIX I

AMENDMENTS TO SECTION 216(d) (SEC. 543(b)(2)(B), I.R.C.)

Alternative (1)

(B) * * * *acquired producing* working interets * * *

For the purposes of this section, the term "acquired producing working interests" means producing working interests acquired by the corporation after the substantial completion of the exploration for, and development of, such producing working interests.

Alternative (2)

(B) * * * *purchased producing* working interests * * *

For the purposes of this section, the term "purchased producing working interests" means producing working interests acquired by the corporation after the substantial completion of the exploration for, and development of, such producing working interests.

The CHAIRMAN. Thank you.

Senator Douglas?

Senator DOUGLAS. Mr. Schlenger, do you have a copy of your statement?

Mr. SCHLENGER. Yes. I submitted about 20 of them the other day, Senator, but I do not have them.

Senator DOUGLAS. I like to get behind the abstractions.

Mr. SCHLENGER. Yes, sir. This is murky, as I said.

Senator DOUGLAS. To get into reality.

Would it be proper for me to ask you how many stockholders there are in Broseco?

Mr. SCHLENGER. There essentially are——

Senator DOUGLAS. Who these people are.

Mr. SCHLENGER. Donaldson Brown.

Senator DOUGLAS. Donaldson Brown.

Mr. SCHLENGER. Owns substantially all of the common stock, and the preferred stockholders happen to be his children.

Senator DOUGLAS. Preferred stockholders do not vote?

Mr. SCHLENGER. No, they do not.

Senator DOUGLAS. Now, what is the fair market value of the assets of Broseco?

Mr. SCHLENGER. $65 million approximately, of which——

Senator DOUGLAS. How is this distributed between securities and oil properties?

Mr. SCHLENGER. As I mentioned here, the estimated value of the oil properties, Senator, is $15 million, and the balance is represented by securities, and by securities I mean publicly held corporations.

Senator DOUGLAS. About $50 million?

Mr. SCHLENGER. Yes.

Now, I would like to point out here, as I pointed out in the statement, essentially all of the securities were contributed at much less value in 1936 and, fortunately, the market has gone up. There have not been substantial changes.

Senator DOUGLAS. Would you be willing to state what the capital gains have been on the securities?

Mr. SCHLENGER. We have not had any substantial capital gains, to my knowledge.

Senator DOUGLAS. That is, no realized capital gains?

Mr. SCHLENGER. Since 1954, sir. From the period of 1936 through 1954, I think the total realized capital gains were about $5 million.

Senator DOUGLAS. I understand. I was not speaking of realized capital gains. Perhaps I should say increase in the value of the assets.

Mr. SCHLENGER. I think, sir, that we are talking someplace in the neighborhood of $40 million.

Senator DOUGLAS. That the original cost of these properties amounted to approximately $10 million, and the present market value is $50 million, an increase in market value of $40 million. I have a memory of a Mr. Brown who was once vice president of General Motors.

Mr. SCHLENGER. Yes, he was.

Senator DOUGLAS. And this has been Du Pont-controlled, so I assume that the holdings are in the various companies in which the Du Ponts had connections, such as Christiana, Du Pont, General Motors.

Mr. SCHLENGER. Not exclusively.

Senator DOUGLAS. Not exclusively?

Mr. SCHLENGER. Their largest holdings represent about a third, which is in a corporation which, as far as I know, the Du Ponts are not controlling. That is Gulf Oil Co.

Senator DOUGLAS. I see. But I mean the major portion is in the Du Pont complex.

Mr. SCHLENGER. No, I would not say that; no, sir. They have substantial General Motors stock, as all of these gentlemen did, and some Christiana. But this is not substantially all or the majority.

Senator DOUGLAS. Let me ask you this: In the last year what was the value of the dividends received?

Mr. SCHLENGER. Last year their total income was slightly in excess of $4 million, of which——

Senator DOUGLAS. I am speaking of dividends.

Mr. SCHLENGER. I wanted to break it down for you.

Senator DOUGLAS. I beg your pardon.

Mr. SCHLNEGER. $2,400,000, approximately, sir, and the balance was attributable to their oil and gas income.

Senator DOUGLAS. Did the company pay any taxes last year?

Mr. SCHLENGER. It did not pay taxes, but it paid dividends approaching $900,000. It paid almost $900,000.

Senator DOUGLAS. I understand.

Mr. SCHLENGER. It did not pay any corporate taxes because of the dividends received credit.

Senator DOUGLAS. When was the last year the corporation paid corporate taxes?

Mr. SCHLENGER. After 1954; for 2 or 3 years it did.

Senator DOUGLAS. So since 1954, it has not paid any corporate taxes?

Mr. SCHLENGER. Oh, no. In three of those years, I point out that it has had taxable income since 1954. I think it is 3 years.

Senator DOUGLAS. Then since 1957, you say——

Mr. SCHLENGER. I think it is about since 1958 or 1959, it has not paid because of the dividends received credit.

Senator DOUGLAS. Now, despite the fact that it has large dividend income it has not paid taxes, is that true, for most of this period of time?

Mr. SCHLENGER. Not at the corporate level, but their top rate——

Senator DOUGLAS. I understand. That is what we are speaking of.

Mr. SCHLENGER. Yes.

Senator DOUGLAS. How has this been done? What credits have you used, tax credits have you used, to offset dividends so that you do not get corporate taxable income?

Mr. SCHLENGER. Well, the provisions are quite simple. I am not bragging about them. First of all, there is the dividend received credit, the 85 percent intercorporate dividend credit; and the second thing is that by expensing a great deal of our oil and gas expenditure, your intangibles and your depletion, you wind up with a loss at this stage.

Now, I wanted to point out, though, as I told you before, even though we are engaged actively in the oil business, during the period after 1954, in three of those years we did pay corporate level income taxes, and we have paid out last year, as I said, it was close to $900,000 the year before about $600,000, which was 91 percent income.

Senator DOUGLAS. Is it true that prior to the acquisition of the oil and gas properties that Broseco was classified as a personal holding company?

Mr. SCHLENGER. It did not acquire them, sir. It was a personal holding company when it was formed in 1936, and it never made any pretentions to be anything else.

Senator DOUGLAS. And paid taxes as a personal holding company?

Mr. SCHLENGER. It paid two types of taxes. It paid the personal holding company tax at the corporate level or it made distribution to its shareholders who were in the top brackets and who paid individual taxes.

Senator DOUGLAS. But when it acquired sufficient gross income from its oil interests it was able to avoid the personal holding company classification.

Mr. SCHLENGER. I think this is a conclusion some people might make. I would not with all due deference, because this is not a case, again using the word "acquired," where they went out and bought a package of oil properties that was a sure thing.

Senator DOUGLAS. What is "working oil interests" as——

Mr. SCHLENGER. As I use it here—we have a great expert from the staff right here—it is the lessee's interest who is doing the work, who is doing the operating. He will go out and he will risk his money.

This is distinguished, Senator, from the case about which the Treasury is worried. There was a case in the tax court on it, and that is where an investment firm would offer several million dollars for existing, producing working interests, and you can calculate your cost depletion and, therefore, you can calculate your income tax shelter. We never had any such assurance. We have been wildcatting.

Senator DOUGLAS. Let us see if we can get at the facts.
Mr. SCHLENGER. Yes, sir.
Senator DOUGLAS. You say that the company received approximately $2½ million in dividends.
Mr. SCHLENGER. A little less; yes.
Senator DOUGLAS. What were the other items of gross income which it received, and what did they amount to, using these in the economic and tax phrase terminology?
Mr. SCHLENGER. Almost all of it was from the sale of oil and gas.
Senator DOUGLAS. From the sale?
Mr. SCHLENGER. Yes, sir.
Senator DOUGLAS. What was the total?
Mr. SCHLENGER. Approximately $1,600,000. So you would see that even if you called this a shelter, there is no four-to-one shelter here such as the packaged arrangement.
Senator DOUGLAS. What were the deductions which you made so that you did not pay a tax on the dividends received?
Mr. SCHLENGER. The deductions were, as I stated, sir. They were the normal expenses of operating the oil and gas business, wages, salaries, and so forth.
Senator DOUGLAS. Yes.
Mr. SCHLENGER. Drilling expenses, depletion, and that provision——
Senator DOUGLAS. What about drilling and developmental costs?
Mr. SCHLENGER. Yes, sir.
Senator DOUGLAS. Those were deducted?
Mr. SCHLENGER. Yes, to the extent permissible.
Senator DOUGLAS. Were they deducted from the gross income of the oil properties or from the total amount of passive income or dividends which you received?
Mr. SCHLENGER. Without having the precise figures in my head, I think you could say that all or almost all of such deductions could be allocated to the oil and gas sales income. There was some spillover.
Senator DOUGLAS. This is very important. Did that $1.6 million become--did that have already deducted from it depletion—pardon me, drilling and developmental costs?
Mr. SCHLENGER. No.
Senator DOUGLAS. Would you answer——
Mr. SCHLENGER. This was my gross, $1.6 million, and then the deductions were made from it, sir.
Senator DOUGLAS. And this served as a sufficient tax credit so that you did not have to pay taxes on $2.5 million received in dividends.
Mr. SCHLENGER. For three reasons, if I could mention them, three items:
First, there was the 85-percent provision which applied specifically against the dividend income, leaving us only 15 percent; and the bulk of the eating up of this remaining 15 percent; and the bulk of the eating up of this remaining 15 percent was attributable, per my recollection, to the deductions for depreciation of substantial equipment which we had on hand, because I think we have about a $2 million investment in equipment, plus depletion.
Senator DOUGLAS. Isn't, in practice under our tax law, the drilling and developmental costs—aren't they treated as an operating expense?

Mr. SCHLENGER. Yes.
Senator DOUGLAS. What?
Mr. SCHLENGER. Yes. But I think, perhaps——
Senator DOUGLAS. Well, therefore, should you not have computed the income as your net income from dividends, plus your net income from oil?
Mr. SCHLENGER. I am not certain for what purpose, sir.
Senator DOUGLAS. Well, to get at taxable income.
Mr. SCHLENGER. To get at taxable income here we take and aggregate all of our income which is oil and security income, and then take all the deductions to which we are entitled.
There is one modification under present law, per a ruling of the Internal Revenue Service, in determining gross income from the oil and gas interests. We subtract from that the lifting costs, the costs of bringing the oil up. This must be deducted, and in our case this was a reduction, per my memory, from $1.6 million down to $1,150,000.
Senator DOUGLAS. I think the issue is where the deduction should take place. Should it take place after gross income from oil plus dividends are lumped together, and then permit the deduction used as an offset against the 7.8 percent intercorporate tax? Or should the deduction be first taken against the $1.6 million gross income from oil, and then any net income left added to the $2.5 million in dividends, under which condition the $2.5 million in dividends would be subject to taxation?
Mr. SCHLENGER. Could I say something on that, sir?
Senator DOUGLAS. Certainly.
Mr. SCHLENGER. If this line of reasoning had some plausibility, and perhaps it does, I think our position may have been misconstrued, and it is that any change in oil and gas policy, whether it is a change in, say, dropping percentage depletion, we feel should be made clear across the board in the oil and gas industry, whether it is a company like Broseco which is actively engaged in increasing its production, and closely held, or whether it is a publicly held company.
We find ourselves in this dilemma, sir, that if we followed your approach we would be substracting from our income, our oil income, these various items which you enumerate. Other companies would not be faced with this same problem, and we feel that we would be treated unequally here.
Senator DOUGLAS. This is again a very technical subject, but I have never thought that the writing off of drilling and developmental costs, which is very liberal in the case of oil, up to 75 or 80 percent in the first year, that this was taken from profits. I thought it was treated as an expense item just as the depreciation of machinery is treated.
Mr. SCHLENGER. We treat it as an expense, sir.
Senator DOUGLAS. But only after you have included the corporate income and the dividends from other corporations. That is the point. And with the small amount of the tax, only 7.8 percent of dividends from other corporations, this serves as an offset.
Mr. SCHLENGER. Yes.
I am not certain yet—perhaps I am being obtuse—that I fully understand your point, Senator. I think maybe we tangled each other here.

Senator DOUGLAS. May I ask a question? How much were your drilling, were the drilling and developmental costs in 1962 that you used as a writeoff?

Mr. SCHLENGER. I am trying to remember, but I think somewhere in the neighborhood of about $1 million, $800,000.

Senator DOUGLAS. Assuming it is $1 million, wasn't your net income from your oil properties or activities, whichever one you want to use, not $1.6 million but $1.6 million minus $1 million, or only $600,000, and should you, therefore, have credited your $1 million as an offset against a 7.8 percent tax upon $2.5 million?

Mr. SCHLENGER. This raises a policy question, sir. I am not sure that it is an automatic——

Senator DOUGLAS. You are quite right. It raises a policy question.

Mr. SCHLENGER. And that is the very reason we are here.

Senator DOUGLAS. Yes, I know. That is the very reason I am questioning this.

Mr. SCHLENGER. We think we would be put out of the oil and gas business if this provision were to pass without at least a 2-year deferral.

What we are really saying here is even if there are differences in your judgment as to the merits of the suggested statutory language change, that a 2-year provision would give us the chance to demonstrate that we really are expanding into oil and gas business and go and make a full commitment that would meet all of Congress standards, changed as they would be.

Senator DOUGLAS. I do not want to use any question-begging term, but are you saying that "possibly we have done something wrong in the past but give us 2 years in which to correct"?

Mr. SCHLENGER. No, I do not think we have done anything wrong in the past unless we can say that Congress did something wrong in granting us the privilege, sir, and I would not daresay that.

Senator DOUGLAS. There are many loopholes in our tax laws which we are trying to correct. You may charge us with ignorance, but please do not charge us with guilt.

Mr. SCHLENGER. These provisions have been there a long time, and I think the parallel, sir, would be in the produced film rental situation about which——

Senator DOUGLAS. You see, with the accumulation of knowledge we are trying to correct some of these things. Don't close the gate upon our improved knowledge. Don't say we cannot improve.

Mr. SCHLENGER. I second that heartily, sir. But I think when you change a longstanding policy, whatever its cause, that sometimes you have provisions—there are a number in there already, one to take care of qualified indebtedness in the real estate field, where we had the real estate shelter, if you want to call it that. The other would be the 2-year liquidation provision which would allow you to pull out that way.

We do not actually want to liquidate, but we want to develop as an operating company and develop more, and all we ask is the same 2-year period.

Senator DOUGLAS. Now you mention about your expansion into the oil industry, and I take it that by getting more than 20 percent and so arranging your income account that more than 20 percent was ob-

tained from oil, you were able to escape classification as a personal holding company.

Mr. SCHLENGER. Yes, sir. But our percentage, sir, was closer to 40. It was about 35 percent; that we are pushing at now, under the—wait a minute, no, I am wrong. It was about 40 percent, I think, when you take $1.8 million over approximately $4½ million; on a gross income test, something over a third of our gross income.

Senator DOUGLAS. That is if you include all of the $1.6 million.

Mr. SCHLENGER. That is right.

Senator DOUGLAS. But if you write the $1.6 million done by the drilling and developmental costs, if they are written off and, incidentally, they are written off for tax purposes——

Mr. SCHLENGER. Yes, sir.

Senator DOUGLAS. Say in the ordinary business, you do not pay taxes on gross income. You pay taxes on adjusted net income.

Mr. SCHLENGER. We attempted to comply with the regulations and the statutes as they are.

Senator DOUGLAS. Let us go back to this question on the oil and gas properties. Did you float securities to go into the oil and gas business?

Mr. SCHLENGER. Absolutely not.

Senator DOUGLAS. How did you finance it? You have spoken of putting in large amounts of money.

Mr. SCHLENGER. We had two ways of financing, sir: One, from the income yield from the securities.

Senator DOUGLAS. How much of this income has gone into oil and gas?

Mr. SCHLENGER. It would vary from year to year. We try to take every commitment——

Senator DOUGLAS. Do you have a total in your mind?

Mr. SCHLENGER. So far they have put in something over $10 million in capital outlays.

Senator DOUGLAS. Is this tax-free income? Has this income previously been taxed, because a corporation is enabled to get writeoffs?

Mr. SCHLENGER. Some of it has been taxed in the 3 years I mentioned. I must admit it was small in comparison, but some of it has been.

Senator DOUGLAS. But the major portion, the major portion of this investment, is tax-free income.

Mr. SCHLENGER. Up to this point. I would like to mention recently the corporation bought a ranch, a large one, in Texas for exploration for oil; also for cattle, but primarily for oil. It had to pay many millions of dollars. It had to borrow this and it had to liquidate securities.

Senator DOUGLAS. I was excluding any real estate.

Mr. SCHLENGER. This is for oil; we are going to use it for looking for oil.

Senator DOUGLAS. But, in the main, the expansion has taken place from tax-free income.

Mr. SCHLENGER. Only because we have not hit a big field yet.

Senator DOUGLAS. I understand. Of course, ordinary corporations will pay a tax on net earnings prior to reinvested profits, isn't that true?

Mr. SCHLENGER. Yes.

Senator DOUGLAS. But you have not.

Mr. SCHLENGER. Only because Congress, as a matter of policy, has, as I understand it, allowed corporate profits on which one tax has been paid, to be shifted.

Senator DOUGLAS. Look, I am not charging you with doing anything illegal at all.

Mr. SCHLENGER. No, sir. I do not think we have.

Senator DOUGLAS. Please dismiss that from your mind. I am not charging you with doing anything illegal.

The question is whether we should so adjust our tax laws in the future as to plug a possible truck hole.

Mr. SCHLENGER. Well, my answer to that, I did not want to be evasive, is that the Treasury has collected one tax at the corporate level from the corporation which is paying the dividends, and there is a legitimate policy question, it seems to me, whether you want to impose——

Senator DOUGLAS. Then you question this whole matter of intercorporate dividends.

Mr. SCHLENGER. Yes.

Senator DOUGLAS. You think that should be repealed?

Mr. SCHLENGER. No; I did not raise that. I said there is a question at what point a second tax should be imposed. At the present time the policy, as I understand it, is you do not impose it.

Senator DOUGLAS. If you will forgive me, did you propose that this tax of 52 percent upon 15 percent corporate dividends be repealed?

Mr. SCHLENGER. No, sir; I am not saying that.

Senator DOUGLAS. All right. Then you admit that is correct as a general policy?

Mr. SCHLENGER. In my personal opinion, it is correct.

Senator DOUGLAS. Good.

Well then, you found sufficient offsets with this income so that it was tax free, and you used this to go into the oil and gas business which still further increased the tax offsets which you could use.

Mr. SCHLENGER. Up to a point, until the day of reckoning comes, and it has to some extent. The day of reckoning, for one, was when we had to sell securities to buy this ranch; secondly——

Senator DOUGLAS. Look, in a $65 million corporation, the purchase of a ranch could hardly be a catastrophic occurrence unless it is something similar to the King Ranch in Texas.

Mr. SCHLENGER. I said, sir, this was in the millions.

Senator DOUGLAS. Well, you have got a $65 million property here. You can hardly be weighted down as Atlas was, in Greek mythology, by the weight of the world, by the purchase of this ranch.

Mr. SCHLENGER. I think a lot would depend on who is sketching the picture, but our geologist friends tell us if we had some fairly good luck in wildcatting, that even our substantial resources could be pretty quickly used up, that we would have to sell, pay a tax and then reinvest to develop oil and gas wells which we have found. We hope that we would be placed in the wonderful position. We have not yet been.

Senator DOUGLAS. Just what is it you are proposing?

Mr. SCHLENGER. What I am proposing, sir, is this: I agree with the Treasury's proposal that we should prohibit the purchase of oil and gas

interests from outsiders so that you can predict what your cost of depletion is going to be, put your dividends in and shelter them in a predetermined mix.

Senator DOUGLAS. You think the Treasury is on the right track then?

Mr. SCHLENGER. On that point, on that particular point, no question about it in my mind.

Secondly, we would say that the reductions which the Treasury proposes from gross income, from working interests, should be limited to those situations where we are talking about acquired producing working interests, which means acquired from a third party as distinguished from substantial development by yourself, as we do.

Senator DOUGLAS. I wonder if you would help me——

Mr. SCHLENGER. Yes, sir.

Senator DOUGLAS (continuing). By telling me how you define a working interest as distinguished from an ownership.

Mr. SCHLENGER. All right. As I am using the expression you, Senator, own a piece of land, and you give me a lease upon it. You retain the royalty interest.

Senator DOUGLAS. Generally one-eighth; isn't that true?

Mr. SCHLENGER. Yes; and I am Broseco there. I am going in and I am going to wildcat on your land, I am going to spend my money. I may get a tax deduction for it, but I may not have anything to offset it. This is problematical, this is risky.

Senator DOUGLAS. You do the drilling?

Mr. SCHLENGER. I do the drilling and I take the risk, and I make——

Senator DOUGLAS. In practice on how many of these properties do you do the drilling and how many, in turn, do you subcontract out to other drillers?

Mr. SCHLENGER. What we do is what many people in the industry do, we get a drilling company and pay them to do the physical drilling.

Senator DOUGLAS. Yes.

Mr. SCHLENGER. Not for tax purposes.

Senator DOUGLAS. Who takes the risk under those conditions?

Mr. SCHLENGER. We do; we take all the risk.

Senator DOUGLAS. You do.

Mr. SCHLENGER. We pay all the money.

Senator DOUGLAS. They take no risk?

Mr. SCHLENGER. Not if we are just entering into a regular arrangement where we pay them a straight fee; no.

Senator DOUGLAS. You pay them a straight fee?

Mr. SCHLENGER. Yes, in most of the cases, to the best of my knowledge.

Senator DOUGLAS. What was that?

Mr. SCHLENGER. To the best of my knowledge in most of our cases they do, sir. I am not sure that this is always true in the industry.

Now, if I could pursue that example. One further distinction about which the Treasury is talking and with which we agree, I now hold a working interest, I have developed it. I now sell it to Joe Brown in New York, and Joe Brown has acquired a working interest which is already producing. I have developed it. He acquires it. He knows pretty well from geological reports how much oil he can expect. We have reached that degree of perfection in the art.

He then forms a new Delaware corporation, they transfer these interests to them.

He also takes and dumps in, say, $10 million of securities. That is the vice which the Treasury is most concerned about or at least it stated so in its report, and that we would have covered by the suggested language I have prepared.

Senator DOUGLAS. You say you do some of this drilling yourself?

Mr. SCHLENGER. We contract for it all. We are in charge of it. In other words, we have a drilling company come in and they bring their rigs, for the most part.

Senator DOUGLAS. How many men work for you?

Mr. SCHLENGER. Through the whole thing when you take into account the employees of the driller and all, I was informed somewhere between 150 and 200 people.

Senator DOUGLAS. How many of these are employed directly by you and on your payroll, and how many of these are employed——

Mr. SCHLENGER. I think about 20 on our payroll.

Senator DOUGLAS. How many?

Mr. SCHLENGER. Twenty, sir.

Senator DOUGLAS. Twenty are on your payroll?

Mr. SCHLENGER. Yes.

Senator DOUGLAS. And the remaining 130 are on the payrolls——

Mr. SCHLENGER. Of the drilling companies.

Senator DOUGLAS. Of the drilling companies.

Mr. SCHLENGER. Yes, sir. On our payroll are primarily geologists, people who go out searching for oil, make a test here, get the maps, and then they would arrange for the drilling.

Senator DOUGLAS. What expenses of the drilling company do you write off against taxes?

Mr. SCHLENGER. We write off most of it as we go along.

Senator DOUGLAS. This is against taxes, not against gross income but against taxes.

Mr. SCHLENGER. Oh, no, sir. We have to write them off against income before we get to taxable income——

Senator DOUGLAS. I understand.

Mr. SCHLENGER. Or you never get there.

Senator DOUGLAS. Perhaps I will put it this way: you say you get a gross income of $1.6 million from your oil operations. Is this the total income which you get from the sale of oil?

Mr. SCHLENGER. Yes, sir.

Senator DOUGLAS. It is.

Then you lump this with the $2.5 million that you get from dividends, and you write off then the operating costs involved in the oil properties and the drilling and developmental costs, is that true?

Mr. SCHLENGER. For the most part.

Senator DOUGLAS. And you deduct that and use it as credit against the 7.8 percent tax to which you would otherwise be liable.

Mr. SCHLENGER. Only to the extent that all of those deductions combined exceed the $1.6 million, and they do to some extent.

Senator DOUGLAS. What you are saying is that you operate your oil properties at a loss.

Mr. SCHLENGER. At a paper loss at the present time.

Senator DOUGLAS. And you use that paper loss then to avoid the payment of taxes upon the $2.5 million of dividends which you receive.

Mr. SCHLENGER. Well, we do not or I do not think——

Senator DOUGLAS. You are representing not Mr. Brown——

Mr. SCHLENGER. Broseco Corp.

Senator DOUGLAS. Broseco. I am not saying—I am simply saying you are Broseco's lawyer, so when I say you I mean Broseco.

Mr. SCHLENGER. I understand the sense in which you used the word, but I also understand the sense in which you used avoidance. We do not say that it is avoidance to take advantage of the legislative setup so far enacted by Congress.

Senator DOUGLAS. Now, you see, I am not charging you with doing anything illegal.

Mr. SCHLENGER. Yes, sir.

Senator DOUGLAS. I want to make that clear. But I am saying whoever devised this was a very sharp man to avoid paying taxes.

Mr. SCHLENGER. But don't you think, Senator——

Senator DOUGLAS. I am not saying evade; I say avoid.

Mr. SCHLENGER. Senator, I could ask you one question?

Senator DOUGLAS. Yes, indeed, providing it is not too personal. [Laughter.]

Mr. SCHLENGER. I use it in the representative sense, sir.

Senator DOUGLAS. All right.

Mr. SCHLENGER. Wouldn't you think this is an extremely risky way of tax avoidance, as tax shelters go, by entering into the oil and gas business? This is what I think makes it different, makes it unique. We do not have any sure thing here. We are not buying interests that already exist. We are gambling. So far we actually have not been really that lucky. Once we thought we had a real big one. We have not yet made a big hit on this thing, and we are pouring a lot of money in here, and I think it is a rather expensive way to avoid taxes.

Senator DOUGLAS. I would say you can turn losses in the oil industry into economies in taxation for other properties, taxation of income from other properties, and to that degree therefore, your entrance into the industry is subsidized.

Mr. SCHLENGER. Perhaps so, but perhaps the whole industry is to some extent subsidized.

Senator DOUGLAS. As, perhaps, you may know, I have tilted against many features of taxation on oil properties on just this ground, not wholly on this ground, but an added reason is I think that it leads to an uneconomic use of resources; that where people go into an industry for tax advantage rather than for operating for profit you get an uneconomic application of labor and capital.

Mr. SCHLENGER. I would subscribe to that, but I really do not think that was the intent here.

They started going in here into the oil business, as my statement shows, in the late 1940's. They went into it slowly, they got stung sometimes and they expanded, and one of the reasons they went into the oil business was not the tax gimmick, but because Mr. Brown at the time was on the board of directors of the Gulf Oil Corp. He was for a number of years. He learned something about the oil business. One of his sons is now vice president. So this was a long cherished

family hope to develop a large operating oil company. I do not say they were blind to taxes, obviously not, but I do not think that was the primary motivation.

Senator DOUGLAS. Well, years ago I read Oliver Wendell Holmes' book on the common law which you, as an eminent lawyer, probably also read, in which he pointed out that the development of the common law was away from the question of the proof of intent to an examination of the consequences which reasonably a reasonable man could expect from his acts.

Now, I had not realized this question was as complicated when I started to question you, but it opens up great vistas, and I think it raises some very real questions of accounting.

I had always thought that depreciation—mind you, I am not speaking of the depletion for a moment, that is something else—but I had always thought of depreciation as being a cost which should be deducted prior to the definition of profits and, therefore, prior to the payment of taxes.

Now, when I suddenly find it popping up as an item which is used against taxes, this seems to me an aberration or a great error in the present tax laws which it would be desirable to cure.

What you are saying is: "It has been legal in the past; it is not our fault." Of course, it is not your fault, but poor Uncle Sam has made so many errors that sharp people can take advantage of that one really feels tempted to come to the aid of the old gentleman.

Mr. SCHLENGER. If I could speak to that just one last time——

Senator DOUGLAS. Yes, indeed.

Mr. SCHLENGER. I think there may be, in your view, some extenuating circumstances, because it may not be as much of an aberration as you suspect, because we do not see wealthy people flocking into this, and the reason is just what I said before, it is too darned expensive even for taxes. You still have to lay out your money, as I mentioned earlier.

I have been told there are one or two others in this country that might be affected by this, but they have other types of income, real estate plus this. I do not think you will find anyone else like this.

The second thing here, it seems to me, is that this can be dealt with if there are possible abuses here, and they can be dealt with under the unreasonable accumulation of earnings test which is already in the law and is a factual test.

What we are talking about in the personal holding company, what makes it so difficult for some taxpayers, rare ones, is that its provisions are automatic. You make a policy decision when you write the statute. There are no exceptions, and it is to that point that we address ourselves here. We do not think this should be an automatic punitive provision. If they have to have punitive provisions, let them be applied on the factual basis under section 531 of the code.

Senator DOUGLAS. Mr. Chairman, we could probe this matter for a long time, but I have pursued it long enough.

The CHAIRMAN. I would like to ask the witness a question.

Mr. SCHLENGER. Yes, sir.

The CHAIRMAN. I understood you to say you took paper losses. Would you explain what paper losses are.

Mr. SCHLENGER. Yes, sir; in the sense in which we were carrying along the dialog at the time, that many of the expenses which we deducted would be for drilling and that sort of thing which represented a cash outlay in that particular year. By paper losses I referred to depletion which would be percentage depletion, which would not be dollars going out of our pocket at that time, but, of course, you go back then to the theory of depletion; and the same with depreciation, and it is only in that sense that I meant a paper loss.

The CHAIRMAN. You mean depreciation as a paper loss?

Mr. SCHLENGER. It is not a current cash item. You spend on depletion or depreciation, you spend your cash many years in advance, and you are trying to recover in subsequent years. This, as I understand it, is the theory, sir.

The CHAIRMAN. Would you present to the committee a statement of the paper losses that you have taken off your income taxes; how long has this company, the Broseco Co., been in existence?

Mr. SCHLENGER. Since 1936.

The CHAIRMAN. 1936?

Mr. SCHLENGER. Yes, sir.

The CHAIRMAN. Did I understand you to say you have not paid any income taxes since 1956; was it?

Mr. SCHLENGER. I think it is 1956 or 1957, sir, because of the dividend credit.

The CHAIRMAN. Will you furnish this committee with a statement of your income and your expenses and from what sources they come——

Mr. SCHLENGER. Yes.

The CHAIRMAN (continuing). Since the organization of the company.

Mr. SCHLENGER. Yes.

The CHAIRMAN. Please supply also a full explanation of what you term to be paper losses.

Mr. SCHLENGER. We will mark those. We have submitted this information already to the Treasury.

The CHAIRMAN. I do not exactly understand how you take paper losses off your income tax.

Mr. SCHLENGER. Perhaps noncash would be a better word, noncurrent cash.

The CHAIRMAN. You will furnish that?

Mr. SCHLENGER. Yes.

Senator DOUGLAS. Might I also ask the witness to furnish a statement of the taxes paid from 1954——

The CHAIRMAN. What was that?

Senator DOUGLAS. I request the witness furnish a statement of the taxes paid in 1954.

The CHAIRMAN. I want a complete breakdown of the receipts and the taxes paid since the beginning of the company.

The SCHLENGER. The figures are readily available since 1950. It will take some digging prior to that.

The CHAIRMAN. Just send them to the clerk of the committee so that we can embody it in the record, with a full explanation of the paper losses.

Mr. SCHLENGER. Yes, sir; thank you very much.

The CHAIRMAN. Thank you.

(The following was later received for the record:)

VENABLE, BAETJER & HOWARD,
Baltimore, Md., December 4, 1963.

Re Broseco Corp.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Pursuant to your request made during my testimony on December 2, 1963, before the committee, I am enclosing herewith a compilation, for the period 1936 through 1962, of accounting data relating to Broseco Corp.

Pursuant to your request, the attached compilation sets forth the constituent items of Broseco's gross income for each of such years and its deductions for each of such years. In this connection, I should like to point out that, in the compilation, expenses have been broken down into two basic categories:

(1) Current cash deductions which represent items for which cash was currently expended and which are currently expensed; and

(2) Noncurrent cash deductions which represent items which are currently expenses but for which cash expenditures were made by Broseco in prior years. It is this latter category of deductions which was described as paper deductions in the testimony. The meaning of this description is simply that these expenses represent prior years' cash expenditures. You will note, for example, that the deductions for depreciation represent current charges with respect to prior cash capital expenditures. The same is true with respect to cost depletion for royalties and working interests in oil and gas. The same is true for deductions taken for abandonments with respect to oil and gas interests. There is also separately stated the statutory depletion allowed with respect to working interests in oil and gas.

As for the dividends received credit, this represents that credit allowed to a corporation receiving dividends from another corporation, the apparent theory of the credit being that the first corporation, which paid the dividends, had already paid Federal income taxes on the income out of which the dividends were paid. Thus, the dividends paid credit has the intention and effect of preventing double income taxation at the corporate level.

You will also note, at the very bottom of the compilation sheets, the capital additions (other than securities) made by Broseco from 1950 to date, which represent cash investments in oil and gas properties and assets.

The submitted compilation shows that Broseco has expended, in cash, approximately $10,650,000 for capital assets and property in its oil and gas business. This compilation also shows that Broseco Corp. has expended, in cash, approximately $14,950,000 for currently deductible oil and gas business expense items. Thus, Broseco has expended, in cash, in excess of $25 million in its oil and gas business. To date, Broseco's receipts from oil and gas sales have amounted to approximately $10,170,000. During the course of its oil and gas operations, Broseco has taken depreciation of approximately $1,630,000 and depletion of approximately $3,740,000 with respect to all of the previously described cash investments made by it in the oil and gas business.

I do hope that the foregoing satisfactorily clarifies the points raised during my testimony and I would like to take this opportunity to thank the committee for its courtesies extended both to me and to Broseco Corp.

Sincerely yours,

JACQUES T. SCHLENGER.

Broseco Corp., 1950–62, income and expenses

[In dollars; cents omitted]

	1950 (1)	1951 (2)	1952 (3)	1953 (4)	1954 (5)	1955 (6)	1956 (7)	1957 (8)	1958 (9)	1959 (10)	1960 (11)	1961 (12)	1962 (13)
GROSS INCOME													
Dividend income	1,208,310	913,383	880,528	904,381	1,107,733	1,393,419	1,408,834	1,431,879	1,423,097	1,610,893	1,634,650	1,908,094	2,451,212
Interest income	51,672	66,612	106,125	79,168	42,890	34,791	56,246	43,737	80,629	77,126	85,970	83,247	83,881
Oil-gas royalty income	223,672	233,421	207,891	206,132	182,953	198,288	185,349	173,876	142,660	142,401	127,880	116,922	175,898
Oil-gas working interests income				151,820	369,766	613,813	820,989	1,050,901	993,345	1,131,893	1,491,475	1,739,506	1,810,277
Ranch income													123,469
Capital gains—Securities		71,461	3,904					11	7	41,000		20,356	
Capital gains—Oil-gas			2,412					6,371	7,615		[1] 1,076,144		8,166
Capital gains—other													
Other	10,067	197	20	375		1,803	1,362				14,977		39,255
Total, gross income	1,493,722	1,285,074	1,200,880	1,341,876	1,703,344	2,242,114	2,472,980	2,706,775	2,647,355	3,003,314	4,431,097	3,868,125	4,402,158
DEDUCTIONS													
Current cash deductions:													
Oil-gas expenses	119,775	630	7,800	275,096	665,774	887,561	1,270,299	1,402,447	1,797,709	1,851,879	2,361,931	2,180,862	1,258,504
Other expenses [2]	68,363	129,455	90,188	81,573	77,669	66,457	100,980	112,906	84,209	124,935	105,473	167,776	215,268
Noncurrent cash deductions:													
Depreciation	262	265	265	33,173	43,681	85,772	143,287	163,349	150,664	205,758	254,617	259,586	294,458
Cost depletion—royalty	90,282	100,807	96,244	95,880	87,237	228,899	168,126	143,207	139,284	118,917	89,302	78,957	80,056
Cost depletion—working interests	13,771	5,159		48,399	111,451	131,053	129,592	107,360	101,379	98,760	77,071	107,687	61,199
Statutory depletion—working interests [3]					3,391	46,780	93,115	161,882	168,926	187,295	214,303	351,721	315,626
Abandonments				32,426	17,472	6,947	104,738	15,421	130,242	28,362	71,406	59,523	71,452
Dividend received credit	1,005,687	769,172	748,017	659,028	[4] 592,169	[4] 670,349	[4] 393,481	[4] 510,173	1,209,196	1,366,818	1,383,812	1,611,711	2,069,774
Net taxable income	195,583	279,586	258,367	116,299	[4] 104,500	[4] 118,296	[4] 69,487	[4] 90,030	(1,137,010)	(979,414)	(138,457)	(949,699)	(874,798)
Federal tax paid:													
Corporate	75,774	126,702	128,068	54,900	[4] 48,765	[4] 55,976	[4] 30,607	[4] 38,681	0	0	0	0	0
P.H. Co	0	0	0	0									
Sec. 531	0	0	0	0						[5] 225,416			
Dividend distribution:													
Preferred	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000	175,000
Common	1,281,215	665,730	606,425	410,845	0	63,500				69,850	0	460,375	698,500
Capital additions (other than securities)	78,558	0	0	1,529,333	522,388	715,279	489,767	254,881	379,827	811,627	644,808	349,099	[3] 954,355

[1] Sale of nonproducing leaseholds.
[2] Includes contributions and ad valorem taxes and interest.
[3] Allowable depreciation in excess of cost depletion.
[4] As reported, later adjusted by I.R.S. to operating loss and tax refunded.
[5] 531 tax applies to years 1955, 1956, and 1957.

Broseco Corp., 1936–49 inclusive

	1936 (1)	1937 (2)	1938 (3)	1939 (4)	1940 (5)	1941 (6)	1942 (7)
GROSS INCOME							
Dividend income	$295, 473. 62	$876, 578. 92	$390, 627. 95	$813, 080. 40	$875, 285. 93	$879, 912. 88	$502, 154. 03
Interest income		1, 805. 00	1, 901. 43	2, 361. 99	1, 654. 83	7, 645. 52	26, 694. 40
Oil-gas royalty income							
Oil-gas working interests, income							
Capital gains, securities	3, 299. 32	32, 772. 35	4, 558. 96	90, 003. 80	(12, 587. 82)	(7, 995. 00)	
Other income	5, 776. 00				15, 203. 14	5, 077. 58	
Total, gross income	304, 548. 94	911, 156. 27	397, 088. 34	905, 446. 17	879, 556. 08	884, 640. 98	528, 848. 43
DEDUCTIONS							
Current cash deductions:							
Oil and gas expenses							
Other expenses	8, 943. 82	35, 355. 97	15, 140. 99	13, 286. 51	13, 312. 98	14, 711. 18	11, 193. 97
Noncurrent cash deductions:							
Depreciation							
Cost depletion, royalty							
Cost depletion, working interests							
Dividends received credit	251, 152. 58	716, 022. 08	300, 668. 76	652, 484. 15	713, 433. 84	717, 621. 75	407, 705. 93
Total	260, 096. 40	751, 378. 05	315, 809. 75	665, 770. 66	726, 746. 82	732, 332. 93	418, 899. 90
Net taxable income	44, 452. 54	159, 778. 22	81, 278. 69	239, 675. 51	142, 809. 26	152, 308. 05	109, 948. 53
Federal tax paid:							
Corporate	5, 703. 69	21, 916. 13	12, 427. 94	38, 414. 59	35, 429. 23	43, 935. 49	40, 604. 41
P.H. Co					2, 653. 89	2, 780. 13	
Dividend distribution:							
Preferred	175, 000. 00	175, 000. 00	175, 000. 00	175, 000. 00	175, 000. 00	175, 000. 00	175, 000. 00
Common	112, 300. 00	692, 600. 00	178, 500. 00	697, 700. 00	648, 100. 00	654, 000. 00	322, 000. 00
Capital additions other than securities							

Broseco Corp., 1936-49 inclusive—Continued

	1943 (8)	1944 (9)	1945 (10)	1946 (11)	1947 (12)	1948 (13)	1949 (14)
GROSS INCOME							
Dividend income	$518,160.13	$697,501.56	$689,799.62	$628,504.33	$629,280.72	$756,310.83	$854,205.45
Interest income	11,733.84	7,791.11	10,870.99	2,339.63	460.24	69,804.56	38,538.21
Oil-gas royalty income						51,672.29	1,327,512.29
Oil-gas working interests income							10,833.88
Capital gains, securities	163,350.35	153,132.48	322,010.11	3,033,229.32	1,182,041.83	590,823.17	88,964.62
Other income							2,010.00
Total, gross income	693,244.32	858,425.15	1,022,680.72	3,664,073.28	1,811,782.79	1,408,010.85	2,329,154.35
DEDUCTIONS							
Current cash deductions:							
Oil and gas expenses							310,378.78
Other expenses	15,822.87	19,817.90	22,004.38	109,193.30	32,332.62	75,758.21	68,928.08
Noncurrent cash deductions:							
Depreciation					69.30	6,981.47	8,459.85
Cost depletion, royalty							1,109,953.64
Cost depletion, working interests							3,902.06
Dividends received credit	408,344.36	585,863.83	579,572.18	529,341.17	529,012.65	631,382.49	703,402.1
Total	424,167.23	605,681.73	601,576.56	638,534.47	561,464.57	714,122.17	2,205,024.56
Net taxable income	269,077.09	252,743.42	421,104.16	3,025,538.81	1,250,318.22	753,888.61	124,129.79
Federal tax paid:							
Corporate	82,048.35	76,890.00	118,947.65	[1] 757,444.83	325,706.39	207,644.18	33,296.13
P.W. Co		194.19	437.80				
Dividend distribution:							
Preferred	175,000.00	175,000.00	175,000.00	175,000.00	175,000.00	175,000.00	175,000.00
Coupon	272,000.00	430,500.00	425,000.00	226,840.51			200,000.00
Capital additions other than securities						68,201.00	1,889,783.00

[1] Additional capital gains tax on exchange of General Motors common stock for Gulf Oil Corp. common, $55,915.24 paid in 1949.

The CHAIRMAN. The next witness is Mr. John H. Davis of Marketime Drugs, Inc., and Rufus H. Smith Co.

Mr Davis, take a seat, sir.

STATEMENT OF JOHN H. DAVIS, PRESIDENT, MARKETIME DRUGS, INC.

Mr. DAVIS. My name is John H. Davis. I am president of Marketime Drugs, Inc., a large retail drug chain in Seattle. I am also president of Rufus H. Smith Estate, Inc., a family investment corporation engaged in developing real estate. This latter corporation is not now a personal holding company but would be under section 216 of H.R. 8363.

First, I want to thank the committee for granting me the privilege of appearing before you this morning. I am opposed to the tax bill for several reasons. I will limit most of my remarks to section 216 and later comment briefly on other aspects of the bill on which time does not permit a detailed discussion.

The present Internal Revenue Code does not treat lessors and developers of property as personal holding companies if 50 percent or more of gross income is from rents. But section 216 of the new bill makes such a corporation a personal holding company if its passive income from dividends and interest is only 10 percent or more of its gross income. Our corporation and certainly many others like it, would be hit with the personal holding company onus.

I grant that the House gave some recognition to the company which the proposed law would make a personal holding company for the first time. Relief provisions are provided for liquidation and for the paying off of debt, but the relief provisions do not solve all the problems. Relief is provided for the discharge of preexisting debt, but what about new debt to expand a building or funds retained from earnings for new construction? These are out. What would the inevitable result be? Certainly in our case there would have to be no new construction. Multiply this absence of new construction manifold and you would see the falling off of funds going into construction. These circumstances lead to reduced employment in the construction industry at the very time when the Congress is properly seriously concerned about unemployment. Certainly the result of the tax bill in this area should not be something to discourage our economy rather than stimulate it. The loss of new construction could far outweigh the estimated 15 million annual revenue saving by this measure.

The liquidation relief provisions are likewise of limited help. In our case, for example, as in many others, the stockholders include older women and minor children. Undivided interests in real estate and securities for a group such as this would certainly be highly impractical to say the least. Accordingly, I urge that the committee, if it should pass the tax bill, amend this portion of section 216 to provide, as is now provided, that a company with rental income would not be a personal holding company if more than 50 percent of its gross income is from rents.

Now I should like to say a word or two about some overall aspects of the bill. I am opposed to the idea of tax reduction at the time of a large national deficit. The spending of more than you are taking

in simply goes against my old-fashioned sense of economics. We have had enough inflation in this country already. Generally, I am in accord with the views already expressed to this committee by Dan Troop Smith in this area. Secondly, I am concerned about the philosophy of some who believe the businessman is getting a good trade to exchange the so-called reforms for a reduction in rates. I believe it is imperative that the technical changes should be looked at independently on their merits without any reference whatsoever to the income tax rates. Business can easily be lulled into this trade and a year or two later find that rates are up again, but the adverse technical changes are still with us. In fact it would be difficult to see how the rates can stay down if we are to have responsible fiscal management.

While some of the technical changes have merit, the business climate would be hurt with present rates reestablished compounded with such additional burdens as the acceleration of the estimated corporate tax payments.

Accordingly, gentlemen, I urge that the bill not be passed, and I again thank you for the privilege of being allowed to appear before your committee this morning.

I will be glad to answer any questions, Mr. Chairman.

The CHAIRMAN. Any questions?

Senator DOUGLAS. No.

The CHAIRMAN. Thank you very much.

The committee will recess until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

COVINGTON & BURLING,
Washington D.C., November 19, 1963.

Re proposed amendment to section 216 of H.R. 8363.

Hon. HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: I should like to submit for consideration by the Senate Finance Committee the attached statement which urges an amendment of section 216 of H.R. 8363, the section which makes extensive changes in the taxation of personal holding companies.

The proposed amendment would facilitate the liquidation of personal holding companies. It is consistent with prior legislative enactments and is necessary and appropriate in order to prevent hardships that would otherwise result from the substantial changes in the taxation of personal holding companies proposed by section 216 of H.R. 8363.

This statement is submitted on behalf of the Wisconsin Corp., 500 Union Street, Seattle, Wash., a personal holding company that desires to liquidate and distribute its assets to its individual shareholders.

Very truly yours,

DANIEL M. GRIBBON.

STATEMENT IN SUPPORT OF AMENDMENT TO SECTION 216 OF H.R. 8363 TO FACILITATE LIQUIDATION OF PERSONAL HOLDING COMPANIES

I

If enacted in the form passed by the House of Representatives, section 216 of H.R. 8363 would effect the most comprehensive changes in the taxation of personal holding companies since they were first subjected to additional tax in 1934. The section is one of the longest and most complex provisions in the bill, covering 44 pages and requiring an additional 46 pages for explanation in the House report.

It would substantially reshape the governing rules under which personal holding companies have been taxed over the last 30 years. For example, under present law a company becomes subject to penalties as a personal holding company only if 80 percent of its "gross income" is of an investment or passive character. Section 216 would lower the operative percentage to 60 percent and would substitute for gross income a new and more restrictive concept defined as "adjusted ordinary gross income." Other changes would include as personal holding company income a much greater amount of income from sources such as rents, mineral royalties, copyrights, and produced film rents.

Because of these extensive changes, the House has included in its bill relief provisions which would give companies that would not have been personal holding companies, but for the proposed changes, an opportunity to liquidate under section 333 of the Internal Revenue Code.

The general effect of section 333 is to enable shareholders of liquidating corporations to postpone recognition of gain on the appreciation of distributed assets. Any gain on distributed assets which does not represent accumulated earnings and profits or securities acquired by the corporation after December 31, 1953, is not recognized until the stockholder disposes of the distributed property.

The House bill would make certain changes in existing section 333 as applied to companies that would become personal holding companies for the first time as the result of the application of the provisions of section 216. With respect to such companies, the cutoff date for nonrecognition of gain on securities would be moved forward from 1953 to December 31, 1962. In addition, distributions of accumulated earnings and profits would be taxed as capital gains rather than as dividends as is the case under present law.

Our objection is not to the form of relief extended to newly defined personal holding companies, but rather to the failure of the House bill to take into account the burden imposed by the changes upon existing personal holding companies. In the past, individuals and their advisers have been in a position to evaluate with reasonable certainty the advantages and disadvantages attached to personal holding company status. Under rules that have been in effect for three decades, it has been possible to anticipate and plan for the changes that would have to be made to abandon that status when it no longer suited any business purpose. However, the legislation now proposed would change the factors upon which such planning has been made. It would tie these companies to personal holding company status without providing an opportunity to withdraw. The Wisconsin Corp., for example, has had under consideration abandonment of personal holding company status by generating additional income from active sources. But as a practical matter, this course would no longer be open for Wisconsin and others similarly situated upon enactment of the new rules. Under these rules, personal holding company income of such companies would be greatly increased by the changes proposed for treatment of rental, royalty, and other similar income; yet at least twice as much income would have to be generated from "active" sources if they hope to alter their status. "Passive" interests could not be disposed of without subjecting shareholders to substantially increased taxes as any gains would be taxed as dividends upon distribution.

Nor would liquidation be a practical alternative. Ten years have passed since the cutoff date in section 333 respecting postponement of gain on securities has been brought up to date. Throughout this period existing personal holding companies have been, by normal turnover of investments, regularly acquiring securities. Even where such companies have been distributing earnings and profits annually, their shareholders cannot afford to liquidate. Liquidation under these circumstances would compel them to resell the distributed securities in order to raise the amount necessary to pay the tax.

Accordingly, the Senate Finance Committee is urged to advance to December 31, 1962, the cutoff date in section 333 so as to provide existing personal holding companies an alternative to continuing in that status under the new rules. There is ample precedent for such action by the Finance Committee. The predecessor of section 333, section 112(b)(7) of the 1939 code, was first introduced by this committee in 1938 for the express purpose of facilitating liquidation of personal holding companies that had recently been subjected to unexpectedly heavy tax burdens.

Indeed, a number of provisions in the tax laws have been enacted specifically to permit companies to change status without penalty because of changes in the law affecting that status. For example, section 29(e) of the Technical Amend-

ments Act of 1958 was enacted to provide companies an election to return to their original methods of accounting after changes in the law governing accounting methods made previous accounting adjustments disadvantageous. Another example is contained in the regulations governing consolidated returns. Personal holding company status under the tax laws is also analagous to that of companies filing consolidated returns as members of an affiliated group; both are subject to certain penalties because of their status. For many years, however, the consolidated return regulations have clearly provided that an election to be part of a consolidated group may be revoked whenever there is a change in the law "of a character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns" (Treas. Reg., sec. 1.1502-11(a)(2)). Fairness requires that these precedents be followed and that existing personal holding companies be accorded the election to terminate their status whenever the law is amended so as to alter significantly the tax consequences of such status.

There is still another reason why the action taken by the House should be broadened. By equalizing the maximum rate of tax on individuals and personal holding companies, the House has taken the final step toward disregarding corporate entity and imposing the tax on corporate income as if received directly by the shareholder. The House action would put the Revenue Service in the position of disregarding the corporate form for purposes of obtaining revenue, but asserting its importance to prevent the individual from retrieving the corporate assets to himself.

Quite probably the narrow relief decided upon by the House is attributable to the fact that under the House provisions extending relief to newly defined personal holding companies, distributions of accumulated earnings and profits to individual shareholders would be treated as capital gain rather than ordinary income as is the case with such shareholders under existing section 333. Presumably, the Ways and Means Committee believed that in order to protect the revenue it would be ill advised to extend this favorable treatment to shareholders of existing personal holding companies. However, no request is made here to have capital gain treatment applied to accumulated earnings and profits. The amendment proposed here would do no more than reenact the ordinary income provisions of section 333.

In this connection, it should be pointed out that the Senate Finance Committee has noted when recommending similar enactments in the past that revenue loss to be expected from updating the section is "negligible" (S. Rept. 781, 82d Cong., 1st sess., 61 (1951)). No windfall results from advancing the cutoff date respecting existing personal holding companies. Nonrecognition upon distribution does not mean that gain on securities acquired prior to 1963 will escape tax. Recognition of gain is merely postponed until such time as the shareholder disposes of the distributed securities. Here, as elsewhere, the code exacts the usual price for nonrecognition—the basis of assets received is the same as that of the stock surrendered, adjusted for gain recognized on liquidation.

II

Quite apart from the impact of the new personal holding company provisions, there is ample reason, as a matter of tax principle, for updating the provisions of section 333. When the section was first enacted it provided that securities acquired by a corporation after the date of enactment, April 9, 1938, would be taxed to shareholders to the same extent as cash. The purpose of this cutoff date was to prevent the investment of cash in securities immediately prior to liquidation in order to avoid the tax that would be imposed upon the distribution of cash. Thereafter, in order to continue to encourage and facilitate liquidation of personal holding companies, the Senate Finance Committee from time to time updated the provisions of section 112(b)(7), advancing the cutoff date in 1943, in 1950, and again in 1953.

The 10 years that have elapsed since the section was last amended represent the longest period it has been allowed to become outdated. As noted, the longer the section remains unchanged, the less suited it becomes for the purposes for which it was enacted.

Recognizing that the President's proposals relating to personal holding companies presented a timely occasion for again advancing the cutoff date, the Section of Taxation of the American Bar Association recommended in July of this year that the cutoff date in section 333 be moved forward on a continuing basis. There was also testimony in favor of updating the section before the Ways and

Means Committee during its public hearings on H.R. 8363. And at least one bill, H.R. 5469, was introduced in the House calling for a new date of December 31, 1962.

Existing section 333, of course, is not applicable solely to personal holding companies, but also applies to any corporation entering into a 1-month liquidation. Quite apart from the need to facilitate liquidation of personal holding companies, the section should be made current since there is no reason to discourage shareholders of any corporation from liquidating where corporate form no longer serves any useful business purpose.

Two alternative amendments are proposed in the appendix to this statement. The first would advance the cutoff date in section 333 solely with respect to personal holding companies. The second would make the new date applicable to all corporations. Both are drawn in such a way that either one may be added to the bill without changing any of the wording already adopted by the House.

Appendix

Alternative 1 (personal holding companies)

Section 216(g) of H.R. 8363 is amended by inserting immediately after subsection 216(g)(3) the following additional subsection:

"(4) Certain Other Liquidations.—In the case of a liquidation occurring before January 1, 1966, of a corporation which for both of the two most recent taxable years ending before the date of the enactment of this subsection was a personal holding company under section 542, the date 'December 31, 1953' referred to in subsection (e)(2) and (f)(1) shall be treated as if such date were 'December 31, 1962'."

Alternative 2 (all corporations)

Section 216(g) of H.R. 8363 is amended by inserting immediately after subsection 216(g)(3) the following additional subsection:

"(4) Certain Other Liquidations.—In the case of a liquidation of any corporation occurring before January 1, 1966, the date 'December 31, 1953' referred to in subsection (e)(2) and (f)(1) shall be treated as if such date were 'December 31, 1962'."

William T. McCargo,
Pompano Beach, Fla., November 16, 1963.

Hon. Harry F. Byrd,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

Dear Sir: For those of us who are past 65 and living on a retirement income the proposed tax program imposes greater taxation rather than reduced taxation. Through the years I have accumulated a number of common stocks, the dividends from which helped to offset inflationary costs of living and in fact these dividends constitute my major source of income. I have always felt that double taxation on dividends was unjust and especially as applied to retirees who had a limited income from this source. The dividend-received credit was allowed to offer some relief from this double taxation. This $50 and 4-percent credit is to be discontinued as of 1965 and all dividends are to be taxed at standard rates depending upon total income. I also understand that certain deductions for State taxes (gasoline and cigarette included) will be discontinued in the new tax bill. All of this will increase the amount of Federal taxes which I will have to pay. Florida State taxes have doubled this year as opposed to previous years and added to increased Federal taxes means a reduced standard of living for me. How does this add up to increased spending for me to contribute to national prosperity?

Is it possible to make some exceptions for those of us past 65 years of age who are living on a limited income and unable to earn income through employment? Hospital bills, insurance rates, services because of our inability to do things ourselves all add up to mere existence in the future under this administration's spendthrift ways. There will come a day of reckoning for the indiscriminate wasteful spending.

May these comments be added to testimony which you are now taking in connection with the new tax bill?

Very sincerely yours,

W. F. McCargo.

STATEMENT ON H.R. 8363 BY ROY BLOUGH, PROFESSOR OF INTERNATIONAL BUSINESS, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY, NEW YORK CITY

The revenue bill before you, H.R. 8363, deals with a considerable number of topics, but I shall limit my remarks to only a few.

IMPORTANCE OF PASSING TAX REDUCTION

1. I urge the prompt passage of the tax reduction provisions of H.R. 8363, in the interests of reducing unemployment, promoting economic growth, and improving the long-term fiscal position of the Federal Government. At the House hearings on the bill I spelled out my reasons for this position, and will not take your committee's time to repeat them here.

2. I support the general pattern of the tax reduction of H.R. 8363 in that it provides relief that will help stimulate consumer demand and relief that will improve the incentives for investment and production. A combination of the two is better than either alone for the promotion of economic growth.

My support of tax reduction is not based on concern that we are now entering or are on the verge of a recession period. The economy is strong and rising. If this were an antirecession measure, greater emphasis on reduction for lower income groups would be appropriate. My support of the bill relates to its longer run importance for the country. To place emphasis on growth gives no grounds for complacency about the importance of speed in passing the bill. We have lost billions of dollars of production and suffered much unnecessary unemployment because of the slow course that this bill has taken.

H.R. 8363 NOT A TAX REFORM BILL

3. Despite the structural changes proposed in the House bill, it can in no sense be considered the "reform measure" that was visualized in the early stages of the legislation. The history of tax legislation suggests that shifts in tax burden are most readily accomplished when the overall tax load is being increased or decreased than when no change in total revenue is contemplated. This fact may have suggested the desirability of combining the two. The combination was appropriate, especially because substantial rate reductions in the higher brackets call for elimination of special provisions favoring such incomes. A major argument for introducing those favorable provisions in the first place was the high marginal individual income tax rates.

Substantial revision of the tax system is called for, but it is not realized in this bill. Some of the structural changes appear to eliminate special favors, while others add to them; but for the most part they deal with minor matters.

CAPITAL GAINS AND LOSSES

4. The proposed change in the treatment of capital gains by reducing the percentage inclusion from 50 to 40 percent for gains on assets held 2 years or more is not minor. The present system of dealing with capital gains was placed in the law by the Revenue Act of 1942, certain aspects of which I was in position to observe at close hand. It is a compromise that should not be lightly upset.

I favor a thoroughgoing reexamination of the taxation of capital gains and of types of income that are not in any real sense capital gains but are given the favorable rate treatment which was originated for capital gains proper. The addition to this category of more and more kinds of income constitutes an undesirable erosion of the strength of the tax system and accentuates the inequities of the system.

Moreover, the treatment of capital gains proper is a compromise among a number of viewpoints. Clearly from the viewpoint of equity, taxing capital gains at lower rates than other income in an economy with stable prices is a violation of principles of equity. I shall speak later of the inflation problem.

The difficulty with finding a good way to tax capital gains arises from at least two kinds of complications. One is the realization concept. To tax capital gains as they accrue would for the most part be equitable, but there would always be financial hardships on some persons to consider, also the problems of minority stockholders, and the difficulties of making the system strictly symmetrical between gains and losses. The acceptance of the realization concept, on the other hand, and it has been in our tax system from the beginning, gives the owner of the property more control over the timing of the realization of income than is true of recipients of other types of income.

Our law has gone to the ultimate extreme of allowing the gain to go without any income taxation at all for assets held until the death of the owner—and the old argument that the estate tax takes care of the matter simply is not true as regards equity. I recognize the possible hardships of taxing gains at death, but tax laws have worked out ways of dealing with hardships in other areas and it could in this one.

In this connection it must be said that to call for lowering the capital gains rate on the grounds that it would make capital more mobile—a type of mobility not without its public disadvantages as well as advantages—and to ignore the most basic reason for immobility, which is the avoidance of taxation at death, is, to say the least, remarkable.

The other major factor that makes difficult the determination of a good method of taxing capital gains is that such gains may be the result of various different kinds of changes, some of which may be open to stimulation by those who would use taxation for purposes other than to raise revenue equitably.

For instance, capital gains often are derived from the holding of land while the growth of population, the actions of other persons or corporations, and governmental projects increase its value and income-producing potential. The only contribution the owner of the land makes to the public welfare is to pay taxes, which of course is an important service that must be taken into account. Aside from taxes, the land would get along very well without ownership. Yet we reward this nonfunctional ownership of property with especially low rates of taxation.

Then there are the capital gains that derive from the reinvestment of corporate earnings. The lower rate of capital gains encourages such reinvestment as against the payment of dividends. The economic desirability of encouraging withholding of earnings from stockholders is open to debate. I observe with interest that some witnesses want both lower tax rates on capital gains and lower tax rates on dividends, two developments which in this respect would work in opposite directions. In any event, it is difficult to make a sufficiently strong case for encouraging the withholding of earnings from dividend payment to justify reducing the rate on capital gains to half or less than the rate on dividends.

This does not exhaust the sources of increases in the prices of securities and other assets. There may be cases in which a case can be made on the grounds of incentive for lower rates than are applied to income generally. But it is difficult to see that they justify the low rate on capital gains of the types that I have mentioned.

Special reference should be made to capital gains that reflect general price inflation. There has been little of that for a decade, but of course a great deal between 1938 and 1951. Economically, gains from this source are not a source of taxable capacity.

It must be noted, however, that capital gains are by no means unique in being affected by general inflation; the real values of money and debt obligations, for example, also are adversely affected, but nothing has been done for them in the tax laws.

Indeed, the only adjustment for inflation that I recall is in connection with LIFO inventories, and that provision was first put into the law in a period of deflation to meet price fluctuation, not inflation. A thoroughgoing study of the capital gains tax issue would consider what might be done to adjust capital gains for price inflation. It would also be the application of averaging, which would be eminently highly important for equitable taxation. And it would consider very carefully that major loophole, the failure to tax gains on assets held until death.

I have no expectation that you will undertake a study of capital gains along this line in connection with H.R. 8363. Indeed, I would discourage it, for the passage of the tax reductions must not be delayed. However, I strongly urge the committee not to permit this H.R. 8363 to tamper with the 1942 formula for the inclusion of capital gains. I strongly recomend deletion of the provision that gains on assets held 2 years or over be included at 40 percent and that the maximum total rate on such capital gains be 21 percent. This is no time to tamper with a long-established compromise.

A thorough study of capital gains is long overdue and if and when it is made consideration should be given to many aspects including the points I have made above. If and when changes in the capital gains tax rates are made, it is my hope that they will move toward closer integration with general tax rates, and not farther away from them.

Moreover, it must always be borne in mind that whenever a concession is given to one, it tends to spread. The 40-percent provision does not apply to some income that receives the capital gains rate, but there is no real logic to the exclusion of such income. It can be confidently forecast that any lowering of rates will give rise to the strongest pressures in later years to extend them to other forms of income now granted capital gains rates and that the pressure to extend capital gains tax privileges to more and more income will continue in the future even more powerfully than in the past.

YOUNG, KAPLAN & EDELSTEIN,
New York, N.Y., November 21, 1963.

Re revenue bill of 1963.
COMMITTEE ON FINANCE,
U.S. Senate, Washington, D.C.

DEAR SIRS: I respectfully submit the following comments regarding the revenue bill of 1963:

POLICY COMMENT REGARDING SECTION 250 OF THE BILL—PROPOSED SECTION 1250

In his 1963 tax message, President Kennedy stated that the primary purposes of the tax bill were—

(1) To promote full employment and economic growth by increasing consumer spending and business capital expenditures; and

(2) To eliminate preferential tax treatment now accorded to particular taxpayers.

The increase in capital expenditures was to be accomplished by reducing the corporate tax rate from 52 to 47 percent and thereby increasing the effective rate of return on capital expenditures. (Hearings before the House Ways and Means Committee, pp. 7–8, 15.)

Proposed section 1250 thwarts the objective of encouraging capital investment insofar as it reduces the net rate of return after taxes to be expected by a builder considering the construction of an apartment house or office building, rapid depreciation of said building for 3 years, and then sale of the building.

Moreover, it cannot be said that proposed section 1250 completely fulfills the second purpose of eliminating preferential treatment of real estate investors. Under section 1245, a business which sells depreciable personal property must recognize all past depreciation (not in excess of the gain realized) as ordinary income. Under proposed section 1250, a business selling real property will recognize past depreciation as ordinary income only to the extent in excess of straight line depreciation.

I submit that both of the President's aforesaid objectives would be furthered if—

(1) Real property was subjected to the complete recoupment of depreciation rule now applicable to personal property under section 1245, and

(2) The investment credit was extended to builders.

In this manner preferential treatment granted to investors in real estate would be completely removed. On the other hand, construction would be induced by the tax device which the administration has proclaimed as the most effective and selective means of encouraging capital expenditures. (S. Rept. 1881, 87th Cong., 2d sess., U.S. Code and Administration News 3529, pp. 3529–30 (1962)).

COMMENTS ON SECTION 220 OF THE BILL PROPOSED SECTION 1250 OF THE CODE

1. Secretary Dillon has asserted that a substantial downward adjustment of the useful lives of real property was not made in Rev. Proc. 62–21, 1962, 1 CB because of the lack of a provision for recapture of excess depreciation upon the sale of real estate. (Remarks before Business Council, May 11, 1962, 627 CCH Tax Service (sec. 6408). The Senate report should now commit the Treasury to a statement that it will adjust real estate useful lives if section 1250 is enacted.

2. The House committee's general explanation discusses the situation in which a building erected by a lessee has a shorter life than the remaining term of the lease. Inasmuch as the lessee is permitted in such case to depreciate the cost of the building over its estimated life (rather than the longer term

of the lease), the report indicates that the general rule of section 1250(a)(1), rather than the special leasehold rule of section 1250(b)(2), will be applied to gain realized upon a sale of the leasehold insofar as applicable to the building. The Senate Finance Committee should be asked to note in its report that the aforesaid principle also applies to the cost of acquiring a leasehold insofar as allocable to a building already on the property which has an estimated life which is shorter than the remaining term of the lease (see e.g., *1220 Realty Co.*, 63-2 USTC sec. 9703 (6th Cir. 1963); Rev. Rul. 61-271, 1961-2 CB 49).

3. Section 1250(b)(3) permits the taxpayer to show that the amount of the depreciation allowed was less than the amount of depreciation allowable. It does not, however, permit the taxpayer to show that the amount of depreciation allowed, was more than the amount that was property allowable.

It is submitted that the taxpayer should be permitted to show that it took depreciation in excess of that allowable for purposes of reducing the amount of gain which is to be treated as ordinary income under section 1250. This would make section 1250 consistent with the basic rationale of sections 1311 through 1315 of the code, which is that (*a*) the tax for the current year should be computed on the basis of the correct tax interpretation of past events and (*b*) when, in the current year, the taxpayer takes a position as to past tax consequences inconsistent with that which it took in the prior year, the Commissioner should be allowed to open up the prior year.

4. The House committee report gives only a single elementary example of the applicability of section 1250 to a 351 exchange (technical explanation p. A154). The taxpayer transfers 1250 property with additional depreciation of $2,000 to a corporation in exchange for stock and is required to recognize section 1250 ordinary income to the extent of the $1,000 in boot received. The same principle is applied under section 1245. The House report does not indicate how sections 1245 and 1250 are to be integrated in the usual case in which a taxpayer transfers both section 1245 and section 1250 property to a corporation in exchange for stock and boot. Is the boot to be,

(*a*) Allocated first to the 1245 property;

(*b*) Allocated first to the 1250 property;

(*c*) Allocated among the 1245 and 1250 properties in proportion to the market values of the properties;

(*d*) Allocated among the 1245 and 1250 properties in proportion to the taxpayer's basis for the properties, or

(*e*) Allocated among the 1245 and 1250 properties in proportion to the additional depreciate attributable to each.

The Senate committee report should clarify this point. It would seem that the logical result is to apportion the boot in proportion to the market values of the 1245 and 1250 properties.

5. The House committee's technical explanation states (p. A149) that the taxpayer may elect to report on the installment method, the gain on a disposition to which section 1250 applies. The committee report should make it clear that the section 1250 and capital gain elements of the overall gain should each be prorated against each installment payment.

6. The Senate Finance Committee should be requested to note that the House committee report contains a statement in regard to depreciation in the year of sale, which purports to set forth established law but which in fact sets forth only the Service's position. The House committee's general explanation of the bill states:

"Since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, is not intended to affect this holding."

This is obviously intended to be a statement of the holding in *Cohn* v. *United States* (259 F. 2d 371 (6th Cir. 1958)). The report does not indicate that the well reasoned opinion in *Motorlease Corp.* v. *United States* (215 F. Supp. 356 (D. Com. 1963)) limits the *Cohn* principle to cases in which the taxpayer did not initially make a reasonable estimate of salvage value.

7. Under section 1250(c)(1)(B), the section 1250 holding period of constructed property begins on the first day of the month during which the property is placed in service.

When the taxpayer constructs a building for business use, it may be able to claim depreciation in the period between the completion of construction of the building and the date when it actually begins to use the property (cf. *Carter*

Colton Cigar Co., 9 TC 219 (1947) acq. 1947-2 CB 1, Rev. Rul. 58-133, 1958-1 CB 277). Such a time gap between completion and use may arise when it is necessary to move equipment and employees to the new building.

Thus, the "placed in service" rule may result in the section 1250 period beginning months after the taxpayer has begun to take depreciation. The Senate report might resolve this problem by stating that a building constructed for eventual use in the taxpayer's business is deemed placed in service when it is completed.

COMMENTS REGARDING SECTION 215 OF THE BILL—NEW SECTION 483 OF THE CODE—INTEREST ON CERTAIN DEFERRED PAYMENTS

1. The applicability of the section hinges upon the existence of a "contract" for the sale or exchange of property. In this regard:

(*a*) The word "contract" is not present in the basic sale or exchange provision (sec. 1001(a)). This may lead to some question as to whether section 483 applies when there is not a formal written contract or when there is not the usual bilateral contract to sell, e.g., when there is merely the delivery of a deed against a bond and mortgage. The Ways and Means Committee report fails to clarify this issue.

(*b*) The word "contract" was probably used to render the section inapplicable to a sale or exchange which is deemed to take place upon the liquidation of a corporation (sec. 331) and, in some instances, upon the liquidation of a partnership (sec. 731(a)). It would seem that an explicit provision should be added to the section exempting these "constructive" sales or exchanges. If this is not done, the contention may be made that interest should be imputed under section 483 when a corporation makes distributions in liquidation over a period in excess of a year. The Ways and Means Committee report fails to clarify this issue.

2. The Ways and Means Committee report indicates that the self-interest of the seller would lead him to demand interest were it not for the tax saving that results if no interest is provided for. Because of this inference, it is deemed reasonable to impute interest. (See "General Explanation," p. 72). This reasoning does not necessarily apply in the case of a sale for payments which are contingent as to liability or amount which are governed by proposed section 483(d). In the latter case, it is likely that: (*a*) there were business reasons rather than tax reasons why the seller determined that he would realize more in the long run from payments contingent upon income, for example, rather than from fixed payments and interest; or (*b*) the buyer was unwilling to commit himself to fixed payments and interest as opposed to payments contingent upon the amounts he realizes from the property sold. Thus, the basis for setting aside the agreement of the parties and imputing interest is extremely weak in regard to a sale for contingent payments.

3. Under subsection (c) of proposed section 483, interest is imputed only with regard to payments due more than 6 months after "the date of such sale or exchange" and only when payments under the contract are due more than 1 year after "the date of such sale or exchange."

The "date of sale" language is similar to the "year of sale" language in section 453(b)(2)(A) which provides that the installment method shall not apply to a sale of real property if the payments in the "year of sale" are more than 30 percent of the selling price.

There has been considerable uncertainty under section 453 as to whether "the year of sale" is—

(*a*) the year in which the buyer receives title or the burdens and privileges of ownership which is the general test of when a sale takes place under section 1001 (Rev. Rul. 54-607, 1954-2 CB 177), or

(*b*) the earlier year which a binding contract to sell was entered into. In *Commissioner* v. *Stuart*, 300 F. 2d 872 (3d Cir. 1962) and "Your Federal Income Tax," page 95, it is stated that the sale does not take place when the buyer acquires a mere option to purchase the property. However, both these authorities leave unclear whether a sale takes place upon the execution of a contract to sell, which is binding upon the buyer. In fact, the *Stuart* case may be construed as inferring that for purposes of section 453, a sale takes place upon the execution of a binding contract to sell.

It may be advisable to amend proposed section 483 to explicitly provide that a sale does not take place upon the execution of a contract to sell. The timing is exceedingly important because the "6 months" and "1 year" tests hinge on the date of sale.

COMMENTS REGARDING SECTION 216(D) OF THE BILL, AMENDING SECTION 543 (A) OF THE CODE—PERSONAL HOLDING COMPANY INCOME

1. The Treasury urged that gross rents should no longer be considered the relevant figure for purposes of the gross income test on the ground that real property can be bought with a relatively lower equity investment than would be required in the acquisition of other prpoerty. (Hearings before House Ways and Means Committee, p. 352.) Thus, without making a substantial commitment, a potential personal holding company could generate a great deal of nonpersonal holding company income. This reasoning clearly supports the proposed amendment insofar as it requires the deduction of interest from gross rents. However, the Treasury's argument does not support the proposal to require the deduction of depreciation insofar as it is based on the corporation's equity in the property. It is submitted that in arriving at "adjusted income from rents" only depreciation based on that part of the cost currently represented by mortgages should be deducted.

2. The proposed rule that depreciation is to be deducted in computing the relevant rental income may create unintended problems in regard to the 60-percent test when declining balance depreciation is used. For example, a corporation which constructs and later operates an apartment house, may have zero "adjusted income from rents" in its early years, when its declining balance depreciation deductions and its interest payments are at their peak. In such a case, nominal interest earned on tenants' security deposits or minor investments in Government bonds, may result in the corporation being classed as a personal holding company. This is clearly contrary to the intent of the committee, since the corporation is engaged solely in the active operation of an apartment house. This problem would be resolved, in part, if the corporation were required to deduct only straight-line depreciation in computing its "adjusted income from rent" for purposes of section 543.

3. Section 216(j)(4) of the bill permits, under certain conditions, the liquidation of a foreign personal holding company under section 333. One of these conditions is that all the stock of the corporation be owned at August 15, 1963, and at the time of liquidation by individuals and estates. These is apparently no reason why a corporation should be disqualified because part of its stock is owned by a U.S. partnership. Any gain or dividend on liquidation realized by the partnership would, in any event, be passed through to the partners.

Very truly yours,

STEPHEN S. ZIEGLER.

STATEMENT SUBMITTED BY JOHN W. WINDHORST, OF DORSEY, OWEN, MARQUART, WINDHORST & WEST, MINNEAPOLIS, MINN.

PROPOSED AMENDMENTS AND COMMENTS WITH RESPECT TO THE PERSONAL HOLDING COMPANY PROVISIONS OF H.R. 8363 AS PASSED BY THE HOUSE OF REPRESENTATIVES ON SEPTEMBER 25, 1963

General discussion

The revenue bill of 1963 (H.R. 8363), as passed by the House of Representatives on September 25, 1963, proposes a number of radical changes in the revenue laws defining and governing the tax treatment of personal holding companies.

The announced purposes of the changes are to correct "weaknesses" in the law which allegedly have permitted certain personal holding companies to avoid the confiscatory taxes imposed upon such companies. In fact, if the bill is enacted in its present form, innumerable small, closely held businesses with a variety of sources of income, which in the past have been in no danger of classification as personal holding companies, will suddenly find themselves so classified.

The bill in its present form embodies basic errors of legislative policy, as well as numerous errors in draftsmanship which could result in unwarranted and capricious damage to taxpayers entirely outside the reasons for the personal holding company provisions.

The bill is primarily aimed at companies with rental income. The drafters of the bill apparently envision a world of "high bracket taxpayers" hiding behind a "corporate facade" collecting "risk-free" rental income and "sheltering large amounts" of unrelated dividend and interest income in the corporation. This ·ld exists almost wholly in the imaginative pages of certain tax journals and

finds little counterpart in reality. However, it has infected the present bill in its fundamental approach to policy.

The most basic error of legislative judgment in the bill as it now stands is the unfounded assumption that all closely held real estate holding corporations were conceived in sin for the purpose of tax avoidance. In fact, it is frequently advisable, and sometimes necessary, for reasons wholly apart from taxes, that the ownership of property be in other than the user's hands. Among the most common reasons for this are credit, mortgaging, and working capital considerations which bear most heavily upon the closely held corporation. Moreover, in just such cases, the real estate is often an integral part of what is undeniably a going, non-real-estate business venture, such as housing the plant of a small manufacturing concern.

Moreover, even where the business is solely that of a rental real estate venture with an unrelated landlord and tenant, it is simply not the fact that such rental income is risk free and passive investment income. The business pages of the newspaper in any major city of the country flatly contradict the proposition that there is little risk involved in the ownership of rental real estate today. In point of fact, there is, and has been, a distress market for some time with respect to existing projects in many metropolitan areas. It has been increasingly difficult to secure financing for new proposed rental real estate projects during the past 2 years, and there is no indication that this difficulty in finding risk capital for such ventures is in any way easing.

Finally, the faulty draftmanship of the bill, even if the basic policy assumptions behind the bill were correct, would result in punitive taxes falling with an equally heavy hand upon the 99 legitimate business-motivated real estate holding companies for every 1 tax-motivated "gimmick" company.

The bill contains errors of a technical nature in various provisions which disregard entirely the 29 years of experience which the Congress has had with this type of legislation. These errors would almost certainly result in a need for prompt remedial amendments which would follow hard upon the heels of the bill itself, as has so often been the case in the past.

Moreover, the bill is so constructed that, at a time when a legitimate company is experiencing severe financial or operational difficulties, it may unexpectedly and unwarrantedly become a personal holding company because of such difficulties.

In the technical discussion which follows in this memorandum, there are spelled out the specific flaws in the present bill, both of judgment and execution, together with a number of specific proposed remedial amendments to the bill. However, it should be stated frankly that perhaps the most sensible approach would be to discard the personal holding company provisions of the bill altogether and start rewriting with a clean slate.

TECHNICAL DISCUSSION AND PROPOSED AMENDMENTS

Amendment No. 1

Delete section 545(c)(3)(B) as added by bill section 216(i)(2). Renumber section 545(c)(3)(C) as section 545(c)(3)(B).

Effect of amendment No. 1

Section 216(i)(2) of the bill as passed by the House allows a deduction in computing undistributed personal holding company income for amounts paid to retire qualified indebtedness. Section 545(c)(3)(A) defines such indebtedness, so far as relevant here, as that incurred before August 1, 1963. Section 545(c)(3)(B) excepts from the definition of qualified indebtedness any amounts which at any time after July 31, 1963, were owed to a person considered to own more than 10 percent in value of the taxpayer's stock. Amendment No. 1 would delete this exception.

Purpose of amendment No. 1

When the personal holding company tax was first enacted in 1934, there was allowed as a deduction in computing the income upon which the tax was imposed "Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness * * *." Section 351, Revenue Act of 1934. This provision was added by the Senate for the express purpose of avoiding the "considerable hardship" which would otherwise have resulted from the act as applied

to companies which had incurred substantial indebtedness prior to the effective date of the act. As the report of the Senate Finance Committee stated:

"This will substantially and properly relieve personally owned corporations which have outstanding bonds or other indebtedness that must be met from current earnings before distributions can be made." (S. Rept. 558, 73d Cong., 2d sess., p. 15 (1934).)

The Treasury sought to have this provision eliminated in the revenue bill of 1937, but was rebuffed for the sound reasons stated by the report of the House Committee on Ways and Means:

"* * * the denial of this deduction would cause hardship in numerous cases where, due to the particular circumstances of the corporation, a dividend distribution cannot be made because of a necessity for legal reasons of using the earnings and profits to discharge the debts. Moreover, any loss of revenue caused by the continued allowance of the deduction cannot increase, since indebtedness incurred after 1933 cannot be used as a basis for the deduction. No corporation can be formed for the purpose of taking advantage of this deduction. Furthermore, it is inevitable that the revenue loss must decrease as pre-1934 debts are retired." (H. Rept. 1546, 75th Cong., 1st sess., p. 11 (1937).)

The deduction provided by section 216(i) of H.R. 8363 was written into the bill for the same reasons as the like provision of the Revenue Act of 1934. The House Ways and Means Committee report states:

"In 1934, when the personal holding company provision was first adopted, Congress provided that indebtedness incurred before 1934 by a company which subsequently became a personal holding company would receive a special debt amortization deduction in computing its personal holding company tax. It was provided that to the extent that this debt was paid off, or amounts were set aside to pay off this debt, the tax base for purposes of the personal holding company tax was to be reduced by the amount of the amortization payments. Thus, these amortization payments were treated for purposes of the personal holding company tax as deductions in the same manner as dividend distributions to shareholders.

"Your committee's bill adds a similar provision for indebtedness incurred after December 31, 1933, and before August 1, 1963, in the case of corporations which were not personal holding companies in 1 of the 2 taxable years before the enactment of this provision but would have been had the new personal holding company provision been in effect at that time." (H. Rept. 749, 88th Cong., 1st sess., pp. 84–85 (1963).)

However, the provisions of section 545(c)(3)(B), unlike its forerunners, for no apparent reason and without explanation, make an exception with respect to payments on indebtedness owed to 10 percent shareholders. This exception is unsound and unjust. The same reasons which support the deduction with respect to any indebtedness outstanding prior to the change in the law apply with equal force whether the indebtedness is owed to a third party creditor or a shareholder-creditor. No corporation can be formed for the purpose of taking advantage of the deduction. Further, any revenue loss resulting from the deduction must inevitably decrease. If indebtedness to a shareholder is lacking in bona fides, no express exception is needed to bar a deduction with respect to such sham indebtedness. This is a problem which has been successfully dealt with by the Treasury and the courts countless times in this and other contexts. However, if the indebtedness is bona fide, there is no justification for forcing the shareholder creditor to abandon his position as creditor, thereby altering his economic position in relation to other noncreditor shareholders, or subject his corporation to confiscatory tax rates on amounts paid to retire indebtedness to him incurred prior to adoption of the present bill. The proposed amendment would conform the present bill to prior revenue acts and afford companies paying a bona fide shareholder-creditor indebtedness equal treatment in this respect with companies which had incurred nonshareholder indebtedness.

Amendment No. 2

Delete section 545(c)(5)(A) as added by bill section 216(i)(2). Remember bill section 545(c)(5)(B) as section 545(c)(5).

Effect of amendment No. 2

Section 545(c)(5)(A) as added by bill section 216(i)(2) provides that the deduction for repaid debt allowed in computing undistributed personal holding company income is to be reduced by the total deduction for depreciation and

amortization allowed in years beginning after 1963. Amendment No. 2 would delete this provision.

Purpose of amendment No. 2

Section 545(c)(5)(A) is a novel provision which finds no counterpart in any personal holding company provisions of prior revenue acts. Nor does there appear to be any analogous provision in prior revenue acts generally. The provision is evidently aimed at precluding replacement of depreciable real property by the means of forcing the corporation to use depreciation reserve funds normally accumulated for the replacement of property for the purpose of paying off debt. These deductions are disallowed apparently on the theory that they represent no current cash outlay. However, this totally ignores the basic facts that such deductions are necessary both to charge to a current period capital outlays which have previously been expended and to generate a source from which replacement capital may be expended. This provision appears to be aimed at simply driving out of business the companies affected, since it is obvious that no company operating depreciable real estate can continue in business without making some provision for depreciation. This is a wholly unwarranted subsecton. Amendment No. 2 would remove it from the bill.

Amendment No. 3

Add a new subsection 543(a)(2)(C) reading as follows:

"(C) In applying paragraph (a)(2), neither adjusted ordinary gross income nor personal holding company income shall include dividends or interests received by a corporation from another corporation if—

"(i) the receiving corporation and its shareholders own, directly or indirectly, more than 50 percent of the outstanding voting stock of such other corporation, and

"(ii) such other corporation is not a personal holding company for the taxable year in which such dividends or interest are paid."

Effect of amendment No. 3

Subsection 216(d), as passed by the House, amends section 543(a)(2) to provide that rental income is characterized as personal holding company income even where it represents 50 percent or more of the adjusted ordinary gross income if more than 10 percent of the ordinary gross income of the taxpayer is personal holding company income. The stated purpose of this provision is to prevent income from rents from being used as a "shelter" for large amounts of other personal holding company income. Solely with respect to this provision, and not with respect to the definition of personal holding company income generally, this amendment would exclude from adjusted ordinary gross income and from personal holding company income dividends and interest received from a controlled operating company.

Purpose of amendment No. 3

This amendment is analogous to several similar provisions in prior revenue acts, some of which provisions were adopted with the announced approval of the Treasury.

Under the personal holding company provisions prior to the Internal Revenue Code of 1954, closely held parent industrial, mercantile, and real estate corporations which received dividend and interest income from operating subsidiaries were in continual danger of being held personal holding companies, even though such parent companies were wholly outside the intent of the personal holding company provisions. The problem was a chronic one for any corporation operating to any extent through subsidiaries, and resulted in numerous instances in which corporations unexpectedly became personal holding companies through circumstances entirely outside their control. Consolidated personal holding company returns were not an answer to the problem of the parent corporation, because such returns could not be filed by corporations other than railroad corporations.

To alleviate this inequity, as passed by the House of Representatives, section 542(b) of H.R. 8300 would have extended this treatment to other corporations provided (1) the parent received 80 percent of its gross income from other members of the group for the 3 years immediately prior to the taxable year, (2) no member of the group was a personal holding company if income from other members were excluded from personal holding company income, and (3) no mem-

ber of the group was a corporation excluded from the definition of a personal holding company (H. Rept. 1337, 83d Cong., 2d sess. (1954)).

The Senate modified this provision so as to eliminate the first requirement. In addition, as stated by the Senate Finance Committee:

"With respect to the second requirement, the attention of your committee has been called to the fact that where a corporation receives almost all of its income from subsidiaries, other income, although incidental, may be of the investment type and, therefore, this requirement of the House bill may deny it the right to file a consolidated return for purposes of applying the gross income requirement. Therefore, your committee has provided that income from outside the consolidated group is to be tested under this second House requirement only if it constitutes 10 percent or more of the company's gross income.

"In addition, your committee has provided that dividends received by the common parent corporation from a corporation in which it owns more than 50 percent of its stock shall not be taken into account in applying the 10-percent test."

S. Rept. 1622, 83d Cong., 2d sess. (1954)). The bill as enacted took the Senate form (sec. 542(b), I.R.C. 1954).

A similar provision is found in section 543(a)(9)(B)(ii) of the 1954 code, added by Public Law 86–435, April 22, 1960 (74 Stat. 77). That section was added to the definition of personal holding company income to provide that such income was not to include income from copyright royalties under certain conditions, namely: (1) Such royalties constituted 50 percent or more of gross income, (2) other personal holding company income was not in excess of 10 percent of gross income, and (3) business expense deductions were equal to at least 50 percent of gross income. In applying the 10-percent test, however, the section, as enacted, specifically excuded dividend income from corporations in which the taxpayer had a 50-percent or more stock interest which themselves met the three conditions. The section was not objected to by the Treasury, which stated in a response to a request for its views on the bill as enacted:

"The Treasury Department would not object to the enactment of H.R. 7588. We have been informed that the primary purpose of this bill is to provide relief from the personal holding company tax for certain operating companies in the music publishing business. In our opinion H.R. 7588 will accomplish this limited objective without permitting certain tax benefits which do not seem desirable but which would have been permitted under certain bills introduced during the 85th Congress.

"The Bureau of the Budget has advised that there is no objection to the presentation of this report" (letter to Hon. Harry F. Byrd, chairman, Committee on Finance, U.S. Senate, from Jay W. Glassman, assistant to the Secretary, dated October 22, 1959, printed as appendix to S. Rept. 1041 (Jan. 25, 1960) [to accoumpany H.R. 7588]).

The Treasury commented favorably with respect to the 10-percent test in general and expressed no opposition to the exclusion of dividends received from a controlled operating company in connection wtih the test.

Section 543(a)(4)(ii) as amended by section 216(d) of the 1963 bill as passed by the House is in conformity with the present provisions of the 1954 code on this point.

In each of the instances cited, the Congress has recognized, in the limited spheres indicated, the distinction between holding shares of a corporation for the purpose of collecting the income from such shares and holding the shares of a corporation for the separate and district purpose of obtaining and asserting continuous control over the activities of such corporation. The distinction is one recognized throughout the business and financial communities and also has been accepted many times by the courts in other contexts. Amendment No. 3 to section 543(a)(2), as amended by section 216(d) of the bill, rests upon the same basic distinction as has been made under prior revenue acts, by the courts, and as is made in other provisions of the same bill. If amendment No. 3 is enacted, there would be no avoidance of taxes as a result thereof. The use of dividend income from an affiliated operating company to invest in assets which normally qualify as operating assets in no way decreases the tax revenue which would be derived if the first operating company merely accumulated the funds used to pay dividends and itself invested in the operating assets.

Amendment No. 4

Delete section 543(b)(2)(A) as added by bill section 216(d).

Delete section 543(b)(3) as added by bill section 216(d).

Renumber section 543(b)(2)(B) as section 543(b)(2)(A) and section 543(b)(2)(C) as section 543(b)(2)(B).

Renumber section 543(b)(4) as section 543(b)(3).

Revise section 543(a)(2)(A) as amended by bill section 216(d) to read as follows:

"(2) RENTS.—Rents, except that rents shall not be included if—

"(A) such rents constitute 50 percent or more of the adjusted ordinary gross income, and * * *."

Effect of amendment No. 4

Under section 543(a)(7) of the 1954 code, rents are personal holding company income unless the rents constitute 50 percent or more of the gross income of the taxpayer. While the bill as passed by the House retains gross income with certain modifications not immediately relevant as the measuring rod for most purposes under the personal holding company provisions, in the case of rental and mineral royalty income, the bill proposes to use a net income figure in connection with the 50-percent test. Amendment No. 4 would restore gross income (as otherwise modified by the bill) as the measuring rod for the purpose of determining whether rents meet the 50-percent requirement of section 543(a)(2)(A).

Purposes of amendment No. 4

There probably has been no problem under the personal holding company provisions which has caused so much difficulty and confusion, resulted in so many unintended hardships, and required so much belated mitigating legislation as the treatment of rental income.

As initially passed by the House of Representatives, the original personal holding company provisions included rents as personal holding company income. This was changed by the Senate Finance Committee and the act of 1934 excluded rents from personal holding company income for the reason that:

"A great part of real estate business is done by small family corporations. These partake more in the nature of operating companies than mere holding companies. Your committee is of the opinion that it is unwise to include such companies within the categories of personal holding companies." (S. Rept. 558, 73d Cong., 2d sess., p. 15. (1934).)

However, in 1937, the personal holding company provisions were amended to provide that rents were to be treated as personal holding company income unless such rents constituted 50 percent or more of gross income. By these provisions, the Congress prevented certain holding companies which were not bona fide operating companies from abusing the exemption from the personal holding company provisions of rents. However, the Congress expressly recognized that, in the words of one eminent commentator: "* * * there are thousands of corporations formed to hold and operate improved real estate, that such corporations are formed for legitimate business reasons and are in general actively engaged in business, and that it would be unfair to treat such bona fide real estate corporations as personal holding companies." (Clearly, Personal Holding Company Pitfalls, 9th Annual N.Y.U. Instit. Fed. Tax. 467, 471–72 (1952).) The Ways and Means Committee report on the revenue bill of 1937 stated:

"Under existing law, rents are excluded from the 80-percent classification. This was done principally so as not to interfere with bona fide and legitimate operating companies, whose business consisted of the ownership and operation of office buildings, apartment houses, etc. However, your committee believes that the entire exemption of rents from this classification has permitted certain personal holding companies which are not bona fide operating companies, to escape their just share of the tax burden. To prevent certain holding companies which are not bona fide operating companies from taking advantage of this exception and to protect legitimate operating companies, the proposed bill provides that rents be included in the definition of personal holding company income unless they constitute 50 percent or more of the gross income of the corporation. This will prevent a corporation from getting out of title I A by investing just enough in rents to constitute the gross income therefrom, 21 percent of the total, and still deriving the remainder of its income from dividends,

interest, etc. *On the other hand, it will protect the bona fide estate corporation and other corporations renting property and deriving 50 percent or more of their gross income from rents.* 'Rents' as here used is defined in its broadest sense and includes such items as charter fees, etc., and is not limited to rent of real property" [emphasis supplied]. (H. Rept. 1546, 75th Cong., 1st sess., p. 6 (1937).)

To strike at other "tax gimmick" companies, the Congress also provided in the 1937 act that personal holding company income would include all rents received by a company from a 25-percent or greater shareholder. This provision quite properly eliminated from the tax scene the spectacle of the so-called incorporated yacht. However, at the same time, it struck indiscriminately at the cases where ordinary business property was leased by a shareholder and operated on a commercial basis.

This resulted in such unintended hardships that the Revenue Act of 1950 provided relief retroactively for the years 1946 through 1949 in the case of rents received for the use of the property of the taxpayer by the lessee in the operation of a bona fide commercial, industrial, or mining enterprise. As the Senate Finance Committee report stated:

"Included in personal holding company income are amounts received for the use of the corporation's property where 25 percent or more of the stock in the corporation is held by the individual renting the corporate property. The attention of your committee has been called to examples where, through a set of fortuitous circumstances, corporations have become closely held and also have rented most of their assets for use in the operation of businesses to the individuals holding the stock of the companies. Thus, unwittingly, the corporations have become personal holding companies and subject to the penalty tax.

"While your committee recognizes that such arrangements could result in tax avoidance, and, therefore, does not permit such practices in the future, it believes that relief for past years should be given where such arrangements have been unwittingly entered into with no thought of tax avoidance. Thus, your committee's bill in section 226 limits the application of section 502(f) of the code (defining personal holding company income) to eliminate, for taxable years ending after 1945 and before 1950, rents for the use of a corporation's property by persons holding 25 percent or more of the stock of the company where the property is used by such persons '* * * in the operation of a bona fide commercial, industrial, or mining enterprise * * *.'

"It is anticipated that the revenue loss from this proposal will be nominal." (S. Rept. 2375, 82d Cong., 2d sess. (1950).)

The 1954 code continued the 50 percent rent test, so as to exclude real estate operating corporations from personal holding company treatment. In addition, the 1954 code provided, as a relief measure, that rents from shareholders would not constitute personal holding company income unless the corporation had other personal holding company income in excess of 10 percent of its gross income, with rents from nonshareholders not being included for this purpose. The Senate report stated:

"Under present law cases of hardship frequently arise when a corporation rents property to its principal stockholders. Such rental income is treated as personal holding company income and the corporation may be subject to the penalty tax. This provision was originally inserted in the law with respect to incorporated yachts and residences but has been applied in the case of many legitimate business enterprises. The House and your committee have provided that such rental income is not to be treated as personal holding company income unless the corporation has other personal holding company income amounting to 10 percent or more of its total gross income. In the absence of appreciable amounts of other investment income, rental income received from shareholders does not constitute a tax avoidance problem."

This is, of course, the 10-percent test which now emerges in a completely subverted form as a restrictive provision in connection with the 50-percent test as applied to rents under the present bill as passed by the House.

As a result of the 1950 and 1954 actions with respect to rental income received from shareholders, through legislative inadvertence, in the words of the House Committee on Ways and Means—

"* * * an anomalous situation is presented whereby the rental of property by a company to its principal stockholders is permitted in certain cases with respect to the years 1946 through 1949 and for 1954 and subsequent years, but is classified as personal holding company income for the years 1950 through 1953." (H. Rept. 1353, 84th Cong., 1st sess. (1955).)

Therefore, in 1955, it was necessary to once again enact a curative amendment to section 502(f) of the 1939 code to remove this anomaly.

This tortuous history makes plain the need for extreme care in tampering with the rental provisions of the present code. The one basic test governing such income which has remained the same since it was introduced in 1937, despite all of the other vagaries and blunders concerning these provisions, is that rent is not personal holding company income if it exceeds 50 percent of gross income. It is possible that there may be a sounder method of separating the legitimate operating real estate company from the gimmick company, but the present bill does not provide such a method. A net rental test provides no more of a yardstick by which to measure the actual operating activity of a real estate company than a gross rental test. In point of fact, in periods of operating difficulty the exact opposite would be true. If the Treasury is concerned about such problems as the corporate dividends received credit, high leverage financing, and accelerated depreciation, the place to deal with such problems is emphatically not through an indiscriminate application of the confiscatory personal holding company rates. Amendment No. 4 would restore to the bill the one aspect of the treatment of rental income as personal holding company income which was worked without benefit of palliative legislation for better than 25 years.

Amendment No. 5

Revise bill section 216(d) as it amends section 543(a)(2)(B) to read as follows:

"(B) the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) is not more than 25 percent of the ordinary gross income."

Effect of amendment No. 5

Section 543(a)(2)(B), as amended by the House, as noted above in connection with the discussion of Amendment No. 3 provides that rent income is personal holding company income if the taxpayer derives more than 10 percent of its ordinary gross income for the taxable year from other sources such as dividends and interest. Amendment No. 5 would raise this 10-percent to 25 percent.

Purposes of amendment No. 5

The stated purpose of the amendment of section 543(a)(2), as proposed by the bill, is to avoid the "sheltering" of "large amounts" of personal holding company income. Statement by Hon. Douglas Dillon, Secretary of the Treasury, before the Committee on Ways and Means of the House of Representatives, dated February 6, 1963. It would seem that this purpose is effectively accomplished by lowering the 80 percent personal holding company income requirement to 60 percent and testing the aggregate amount of all types of personal holding company income by that standard, without additional reference and coupling of one type of income with another. However, even if the approach taken by the section as it now stands were accepted, the 10-percent test now in the bill is unreasonably restrictive and could easily and inadvertantly be exceeded in the course of normal operations by any operating rental company which, from time to time has surplus cash in significant amounts placed in short-term investments. Among the likely unintended victims of the 10-percent test would be companies engaged in the leasing of equipment which is used on a seasonal basis or leasing companies which derive a small amount of interest income as a result of credit sales of used equipment. Moreover, in almost any business engaged extensively in the rental business, there can and do occur circumstances which would, through sheer business misfortune, entangle such companies within the net of the 10-percent test. For example, the destruction by fire of an insured major rental property could easily result in the company being subjected to punitive personal holding company taxes during an interim period before reinvestment of the insurance proceeds in replacement rental property. If the "coupling" approach of the subsection as it is now in the bill is to be retained, the percentage test should be raised to at least 25 percent to provide some minimal safety value against this harsh result. Amendment No. 5 would afford this limited relief.

FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION,
Washington, D.C., December 4, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: On behalf of our committee, I would like to express to you our appreciation for the opportunity to present to you and to the members of your committee our views on H.R. 8363 as they affect Federal taxation of timber income.

We note with approval that the provisions of the bill do not increase the capital gain rate on timber proceeds for corporations or for individuals as originally proposed by the Treasury Department.

While in the main, the principle of such capital gain and loss treatment as it applies to the timber gains and losses of individuals is retained, there is one aspect of those provisions in relation to the balance of the bill which we do not believe is in accord with good tax policy.

We respectfully invite your attention to this situation.

Under the bill, if an individual owner holds timber over 2 years and cuts it or sells it under a cutting contract, such timber would be considered to be a class B asset and the gain therefrom would be subject to the inclusion rate of 50 percent and the maximum alternate rate of 25 percent, whereas the capital gain from the disposal of other capital assets, held more than 2 years, such as stocks and bonds, and even timber sold outright would be subject to an inclusion rate of 40 percent and a maximum alternative rate or 21 percent.

This discrimination would have the following effects:

1. It would inevitably introduce new and unnecessary complexities into the Revenue Code.

2. It would discourage the holding and conservation of timber over long periods of time.

3. It would reverse a salutary concept embodied in the code by the Congress 20 years ago which justifiably equated the cutting of timber or disposing of it under a cutting contract with an outright sale. This reversal would break faith with timber owners everywhere who have invested in reliance upon existing provisions of that code, and

4. It would promote a shift of capital investment from individual timber holdings into other types of assets that receive favored treatment. This would interfere with the free flow of capital and is particularly poorly advised at a time such as the present. All forecasts of timber availability have indicated the importance of stimulating and encouraging timber growth by adequate capital investment. This discriminatory provision would impose a relative tax penalty against long-time timber husbandry and in favor of other types of capital investment.

The most recent study of natural resources published (May 1963) entitled, "Resources in America's Future," reaffirms the timber findings of the President's Materials Policy Commission, as well as the most recent conclusions coming from the Department of Agriculture. That study points out that: "Supply limitations are more likely to be a barrier to meeting projected demands for forest products and services than for any other major category of resource materials."

When your committee considers the capital gain and loss provisions of the bill, we would appreciate your taking the foregoing comments into account.

Sincerely yours,

WILLIAM K. CONDRELL, *Secretary.*

RYAN, ASKREN, CARLSON, BUSH & SWANSON,
Seattle, Wash., November 26, 1963.

Re personal holding company legislation.

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D.C.

GENTLEMEN: We are directing this communication to you because of the concern of several of our corporate clients over pending legislation with respect to personal holding companies. They feel, as do we, that this legislation, if passed as presently drafted, would be catastrophic as far as they are concerned.

Using approximate figures and by way of illustration, one of our clients (not now a personal holding company) was incorporated in the early 1900's. It has presently 185 stockholders, who are the recipients of an annual dividend of 40 to 50 percent of net earnings. Through the years, by purchase and inheritance, approximately 55 percent of the company's stock has become concentrated in the hands of five stockholders. The company's real properties return a gross annual income of $175,000. Its stockholdings return an annual dividend income of $25,000. The company has a long-term debt outstanding consisting of bonds in the amount of $250,000 in the hands of some 63 bondholders and a contract of purchase of $75,000. If it is to expand, or even exist, it must have capital available to service its long-term debt, to make capital repairs, and to acquire additional capital assets. It employs some 20 to 30 people.

The effect of the proposed legislation on the foregoing situation is obvious. Its forced liquidation would be a said blow to its stockholders and employees, and to the community.

Thank you for your consideration.

Yours very truly,

JOHN E. RYAN, Jr.

FISCAL REFORM AND ECONOMIC GROWTH

(Richard S. Weckstein, Department of Economics, Brandeis University, Waltham, Mass.)

We have not fully adjusted ourselves to the fact of economic growth in the drafting of income tax legislation. At the time of the passage of a new tax law, anticipated revenue—given rates, exemptions, and deductions—is calculated to be appropriate to the economic conditions prevailing at the moment. If there is full employment the revenue required is approximately equal to the Government's expenditure commitments and anticipations. If there is less than full employment smaller sums of revenue would be appropriate, although we have not entirely adjusted to this fiscal principle either. Nevertheless, even if we wrote our tax laws in this way there would remain a serious inadequacy in them which has now been recognized to produce undesirable results. The trouble is, that with progressive rates and large exemptions, the rate of growth of revenue from the income tax exceeds, by a considerable margin, the rate of growth of GNP.[1] If the proportion of GNP taxed away is correct at the time of passage of the tax law, it is not likely to be correct after a few years have passed. In general, there is a deflationary bias built into the progressive income tax, and under modern conditions the strength of this effect is great enough to slow the growth rate appreciably and to make business-cycle recoveries less vigorous than they would be otherwise.[2]

This undesirable characteristic of our fiscal system is of course a consequence of the progressive features in the personal income tax, and if we were willing to sacrifice progressivity, it would be easy to remove this fiscal barrier to growth. It is unlikely that we would be willing to do this, and indeed it should not be necessary. Moreover, it is the very same progressive feature of the income tax which beneficially stabilizes the economy over the course of the business cycle. The problem we must solve, therefore, is to remove the fiscal barrier to growth without at the same time giving up the contribution the income tax makes to both greater income equality and to cyclical stability.

There are a number of poor conventional "solutions" to this problem. If the Government's expenditures are raised at the same rate that the income tax revenue rises then instead of the tax system inhibiting growth it will finance the rapid increase in the relative size of the Federal Government. To those who believe the Government's expenditures now occupy too small a place in the U.S. economy this may be an attractive solution. However, as this evolution continues we would soon satisfy, and then more than satisfy, most of those who hold this view. It is unlikely that this scheme would produce an optimum-sized Federal budget.

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[1] Between 1955 and 1962, revenue from the personal income tax rose from $28.7 to $45.6 billion, an annual rate of growth of 6.8 percent. In the same period GNP rose from $397.5 to $553.6 billion, an annual rate of growth of 4.8 percent.

[2] The problem has been emphasized by Walter Heller, see An Annual Report of the Council of Economic Advisers, January 1962, p. 80.

The other conventional solution is to cut the tax rates and raise exemptions periodically as it is discovered that the existing tax rates create a drag on the economy. Although the proposal to cut revenue in this way is usually put forward, as it is this year, on the ground that the cut is required by the economy's cyclical condition, it is by no means a reliable or handy solution. Neither Congress nor the administration can be expected to act on such needs on time or in correct amount. Moreover tax cuts become hostage to tax reforms. Perhaps in fact one reason for the difficulty in persuading people that tax cuts are needed is that the measure is not precisely appropriate to the situation. Tax cuts are perhaps acceptable as a means to deal with depression or recession, but it is considered novel and even un-Keynsian to cut taxes at a time of high and rising levels of business activity. By no means all the opposition to tax cuts come from fiscal conservatives who believe in balanced budgets under all conditions. Many fear inflation if taxes are cut; some are concerned with the constraint of the balance of payments, and some simply do not recognize the present conditions (November 1963) as those in which a tax cut seems right. If the problem is a secular squeeze, a tax cut is a clumsy weapon to deal with it, and it would be gracious to recognize the merit in the position of some of the recalcitrants.

The modification I propose to this growth-restrictive property of the income tax is an automatic downward adjustment of individual tax liabilities which have been computed in accordance with a given code. The adjustment should be a specified percentage of computed liability and the percentage should increase annually at a predetermined rate of growth. This rate, however, presumes the answer to a prior question. What is the desired size of the Federal Government's expenditures, relative to the whole economy, under conditions of high employment?

Another way of asking this question is: What is the desired income elasticity of demand by society, expressed politically, for Government goods, services, and transfers? If the desired elasticity is less than 1, for example, then full-employment, income tax revenue should be permitted to grow slower than the growth of GNP. An estimate of the future growth rate of GNP and a decision about the desired income elasticity of demand for the Government's expenditures would together determine the proper rate at which income tax revenue should be permitted to grow. A simple way in which this decision may, as a practical matter, be made, at least tentatively, is to assume the desired income elasticity is equal to 1. In this case the revenue growth rate should equal the GNP growth rate. For the present I shall make this assumption.

In accordance with this assumption, the adjustment in tax liability in the first year after an initial year in which there has been a rate schedule-deductions-exemption combination established, is a subtraction of a percent of computed first-year-after-tax liability equal to the percentage difference between the growth rate of revenue and the growth rate of GNP which may be expected to persist for an extended period into the future.[8]

Accordingly, once a tax structure (rates, exemptions, deductions) has been set, tax liability in the initial year is paid in full; in the first subsequent year something less than 100 percent is paid; in subsequent years final tax liability is adjusted by a series of percentage reductions which depends on the difference between the growth rate of revenue from the tax at full employment and the full-employment growth rate of GNP.

In general, the tax liability in any year $T^*_t = T_t(1-r)^t$, where T^* is final tax liability; T is tax liability computed in accordance with a given structure of rates, exemptions, and deductions; t is the "tth" year, counting from an initial year indexed with 0; and $r = r_b - r_a$, where r_b is the prospective long-term rate of growth of GNP and r_a is the associated rate of growth of the income tax liability T.

If this modification had been appended to the 1954 tax legislation, revenue from the individual income tax in 1962 would have been $43 billion instead of the $45.6 billion which was actually collected. An automatic tax reduction

[8] If the relation between the two growth rates given in footnote 1 is stable and if the relation is linear over the relevant range of growth rate variation, then we may estimate the rate of growth of income tax revenue for the expected rate of growth of GNP in the future. Thus, if we suppose, somewhat optimistically, that the future growth of GNP in the United States will be 4 percent, then tax revenue may be expected to grow at a rate of approximately 5.6 percent. The difference between these two rates, 1.6 percent, is the amount by which computed tax liability must be reduced to obtain final tax liability in the second year.

of $2.0 billion is not a powerful antidepression measure, but it would be well suited to relieve the kind of gradual restrictiveness built into the present tax structure. The size of this reduction should not be judged against the needs of a recession.

Under such a scheme for the computation of tax liability, revenue from the individual income tax would rise at the planned or anticipated rate of growth of GNP, rather than at a rate which is an incidental and often unwanted consequence of a tax law written in order to achieve equity in the distribution of income and possibly greater stability over the course of the business cycle. But how does this change affect the resulting income distribution and cyclical stability?

The saving to taxpayers which is to result from this adjustment is proportional to tax liability. It does not make the effect of the income tax more progressive, and in failing to do so it will not gain some potential supporters. This objection does, however, cut both ways and there is certainly no less opportunity for revision of the tax structure to meet the effective demands for either more or less progressivity. The most troublesome objection on equity grounds is that the structure of the individual income tax is established—in a complex legislative-bargaining process—at a particular level of anticipated revenue, and when the level is changed the structure may no longer represent an equilibrium relative to the political forces responsible for the original law. The special treatment accorded to long-term capital gains, for example, may be acceptable under conditions of very high marginal tax rates, but when these rates are reduced by the proposed revision it might no longer be acceptable to allow the same easy treatment of capital gains. There are, no doubt, a good many such examples involving the point that what is equitable at one absolute level of taxes may not be so at lower levels. But although this point is correct in principle, there are two practical things to be said to justify the neglect of it. It is likely, in the first place, that injustices of this sort do not all work in one direction, and thence the rough balance of burden is not likely to be wholly changed by small percentage changes in liabilities. In the second place, too much importance is not to be attributed to the outcome of the legislative-bargaining process from the point of view of equity, whatever may be thought of it as an expression of the balance of political forces. In view of these limitations to the principle, the practical advantages of a simple rule by which annual adjustments can be made should be given much weight.

The effect of this proposal on the cyclical-stabilizing property of the income tax is possibly the more important of the two sided effects. The personal income tax is the mainstay in the arsenal of automaticity in the fiscal system. Although it has not been easy to increase the stabilizing properties by reforms such as formula flexibility, few would wish to accept any weakening of the income tax's present capacity to stabilize. Fortunately it is not necessary to do so in order to remove the impediment to growth which it now contains. The present proposal does not do so.

Although in some circumstances there may be some perversity in this automatic annual reduction, this is preferable to the consistent deflationary bias of the present unchanging law. A deflationary bias, after all, does not work gradually and imperceptibly. On the contrary, it permits a too easy decline in the recession phase of the business cycle. The automatic ease the progressive tax permits is measured relative to some initial period when it should have been designed to produce a balanced budget at full employment. But as time passes and the income consistent with full employment rises, the ease relative to full-employment income grows less and less. Consequently the ability of the tax to protect the economy against depressions diminishes. Although at the same time the strength of the anti-inflation guard is being increased, it is not a rise conceived to tighten the spring just the right amount. If there is a correct tension it might have been sought in the original law for a given level of full-employment income. As the economy grows the tension increases undesirably. This seems to have happened by the end of the 1950's and early 1960's when the tax law had been essentially unchanged since 1954. Too strong an anti-inflation guard has meant too much resistence to a rise to full employment.

The particular way in which I have suggested the tax cut be scheduled, it seems to me, is consistent with equity and simplicity, insofar as the basic tax law to which this revision is to be applied is equitable and simple. Yet it is possible to wish to arrange for an automatic reduction in scheduled tax revenue but to prefer other schedules for accomplishing it. There are three pivots at

which variation can usefully be considered. One is the rate of growth of GNP which should be assumed for purposes of scheduling a tax reduction. The best assumption may not be the most realistic forecast of GNP growth. Those who wish to hurry the growth of the economy, even at some increased risk of inflation, might prefer to assume a higher rate of growth in calculating the percentage by which the initial calculation of tax liability is to be cut. There may be a kind of self-fulfilling prohpecy here. Giving aggregate demand an upward push may induce a rise in capacity growth. On the other hand if price stability is valued more highly, the assumed growth rate of GNP should be set somewhat lower to moderate the increase in tax ease. In either case it is better to have this policy debate center on a number in this way than to allow differences in the ways people estimate dangers of inflation and prospects for growth to take the much more crude form of favoring or opposing a particular stepdown in the tax rates.

The second pivot over which policy differences can usefully be expressed is over what to cut to reduce revenue. Although a single percentage figure has the merit of simplicity it should not be out of the question to consider producing other results on the distribution of income with slight increases of complexity. More refined changes can be arranged by a simple combination of changing the level of exemptions upward in specified dollar amounts coupled with given fixed percentage tax cuts. As exemptions were moved up the percentage by which taxes are cut would have to be reduced for a given effect and consequently the benefits would be more concentrated at the lower income levels. Other arrangements might require a schedule of percentage cuts which depend on the size of initially calculated tax liability.

The issue raised by these possibilities is not alone, how to retain equity in the tax structure as rates are lowered? The more interesting question is how should we arrange for the redistribution of income through the income tax as we grow richer? Do we believe, for example, that a rich country can better afford to equalize incomes perhaps because the incentive effects of doing so may more safely be borne? Or do we believe that a rich society, in which low-income people have a higher absolute income than earlier, can afford the luxury of greater inequality? These are not questions on which all men of good will must obviously agree. They are questions worthy of discussion in order to find a concensus and as well to discover in ourselves, individually, how we feel. It is not the kind of question, however, which we discuss in the context of growth. And the reason is, it seems to me, that our practice of revising taxes in big steps forces our attention on the structural issues proper to the time. This tends to harden the positions taken by proponents of particular points of view. If change in the structure could be scheduled to vary over time I would expect positions might soften and better compromises could be made.

The third pivot on which differing preferences might be expressed is the rate at which the Federal Government should grow over the long run. There is no question here of fixing that rate in advance, of course, for expenditures can change with or without revenue changes and new tax legislation may also alter the revenue as desired. However, new tax legislation is not easy to write and in fact basic taxes often remain unchanged for long periods. It is wise to adjust to the scheduled growth of revenue to the desired growth of Government expenditures. I do not wish to suggest that the question of Government size suffers from neglect, however the need to set a rate of expected growth of revenue does give the question of Government growth a realistic context in which it is clear that we can control this rate of growth in accordance with our desires and that we need not merely accept results which are an inadvertent consequence of the way we run other pressing business. Many, if not most of the components of the budget can be categorized with respect to the way we anticipate the needs they satisfy to grow as incomes rise. Although specific expectations are never likely to prove to be exact forecasts, it nevertheless seems most reasonable that we should form expectations of this kind. The failure to make these expectations and desires explicit leaves us with an implicit expectation for Government to grow as revenue grows. And then if we later fail to justify this implicit expectation we pay in the coin of deflationary pressure.

At this point of decision, as in the others, increasing the rationality of the fiscal system brings with it the opportunity more clearly to express our social preferences. Equity, economic growth, and growth of the Government's relative size all demand decision which can be institutionalized in greater degree than at present in our fiscal system.

STATEMENT BY ARNO HERZBERG, CERTIFIED PUBLIC ACCOUNTANT[1] IN NEWARK, N.J., TO SENATE FINANCE COMMITTEE

CAPITAL GAIN PROPOSALS AND THEIR ECONOMIC BACKGROUND

The capital gain provisions of the Internal Revenue Code add to an unusual degree to the complications of our tax structure. There are so many side effects of these provisions, a wide range of arithmetical computations, a host of uncertainties and pitfalls that it is safe to say: The more complications we write into the tax laws, the less of an effect these provisions will have on decisions the taxpayer has to make and on the promotion of growth in our economy.

Section 219 of the proposed bill adds to the complications of the capital gain structure. It will add a full new page to every tax return. It will add new computations and recordkeeping. It will add to the uncertainties and question marks in the interpretation of the law. It will thus add to the cost of doing business—for the taxpayer and for the Government. Most of all, it is highly questionable whether the proposed provisions will have the desired economic effect. All facts as they are known today tend to contradict the intentions and reasons why section 219 was adopted by the House.

The report of the House Ways and Means Committee states that the inclusion factor of assets held over 2 years was changed in order to "unlock" capital investments where the investor is willing to undertake new and riskier investments, but finds it unprofitable because of the substantial tax liability he incurs at the time of the sale of his holdings.

The so-called locked-in problem has been repeatedly made the subject of studies on the part of congressional committees. It is interesting to note that the present Chairman of the Council of Economic Advisers, Prof. Walter W. Heller, in a paper to the Joint Committee on the Economic Report in 1955 clearly stated that "the extent, severity, and economic impact of the lock-in effect have been seriously overrated."

Since Professor Heller rendered his report new surveys and new developments tend to confirm his observation as of today.

According to figures submitted to your committee a net of $1.6 billion worth of stocks was liquidated by individual investors in 1962. On balance, stock sales exceed purchases by individuals during the period 1959–62. This means that the present capital gain provisions are obviously not interfering with the turnover of securities. This is an important fact because about 50 to 75 percent of all capital gains made by individuals are the result of a sale or exchange of corporate securities.

As long as we have a capital gain tax, a certain percentage of investments will be locked in. In the first place, a taxpayer must anticipate a 25-percent profit in his new purchase just to come out even on the transaction. Whether we decrease this percentage or not, it does not make much of a difference. Secondly, there are taxpayers who, by their very nature, are not in a class that ordinarily takes risks. Thirdly, there are investors that are not faced with tax problems at all.

We have seen the rise of the pension and mutual funds which today hold about 20 percent of the dollar value of stocks listed on the big board. These funds surely have no tax problems; as such they do not have to pay any capital gain taxes on their transactions. A study conducted a few months ago by the University of Pennsylvania found out that 18.2 percent of all shares are owned by retired people who are not the type to take risks or to be concerned with unlocking their investments. Another 18.8 percent is owned by professionals and 34.6 percent by managers and proprietors. How far they will be guided by tax considerations might be viewed in the light of another survey conducted by the New York Stock Exchange. This survey found out that 70 percent of all investors are not decisively influenced by tax questions.

But why is it important to unlock investments?

It is said that our economy has to have more risk capital in order to grow. This argument is not borne out by the facts.

In the first place, there is plenty of capital available. Every new issue of capital stocks or bonds, brought out by industry or Government, is oversubscribed. We know that before the market declined in 1962, enough risk capital was brought into the market to absorb the most speculative, if not outright

[1] Author of "Saving Taxes Through Capital Gains" (Prentice-Hall, 1957).

valueless issues put out by corporations going public. In 1961, the highest amount of corporate securities was offered to the public. In general, corporations generate enough capital internally, by increased depreciation rates or other means, to take care of their long-term needs. If we take a look at the mounting savings in this country, we wonder why that much money has not been invested in other ways. Savings-type assets in the form of time deposits in banks, savings bonds, short-term securities, savings and loan shares, and postal savings have increased 20 percent since 1960 and 41 percent since 1957. In 1960 savings of $260.8 billion constituted 52 percent of the gross national product (GNP). In 1961 savings amounted to $282 billion or 54 percent of an increased GNP. Savings in 1962 jumped by $31.8 billion to 57 percent of GNP. Savings thus increased within 3 years by $53 billion, the GNP by only $50.9 billion. Savings have clearly outpaced the overall expansion of our economy.

It is interesting to note that the bulk of savings are in consumer's hands. Each year between 1957 and 1962 consumers put from 6 to 8 percent of their after-tax income into savings. In 1962 the additions amounted to a record figure of $26.2 billion or nearly 7 percent of after-tax income.

Money would not have been saved at such a rate if proper risks would have been existing or if the economic and political climate in this country would have been more conducive to investment.

And there is another conclusion we have to draw from this avalanche of savings. The theory that we have to put more money in the hands of the consumer by way of a tax cut it not borne out by the facts.

SECTION 219 AND ITS REPERCUSSIONS

An analysis of the proposed section 219 shows two overriding facts:

1. An almost identical breakdown according to holdings periods was on the lawbooks in 1934. It was revoked in 1937 because it did not work under an even less complicated Internal Revenue Code.

2. Suppose there would be a lock-in problem and suppose there would not be enough risk capital available, the proposed cut in capital gain taxes would not accomplish anything in helping to solve these two alleged problems.

In 1934 a sliding scale of percentage inclusions was enacted. There were five holding periods and various percentages of gain were included in ordinary income. The effect was and the effect will be under the proposed bill that the investor will wait (if he waits that long) until he gets the best tax deal and capital mobility is further impaired. A multiple holding period in the form it is proposed becomes a locking rather than an unlocking device. Authority for this is a Treasury Department study from the year 1951 which clearly states "The 1934–37 plan operated to postpone selling appreciated investments because of the tax advantage of the longer holding period." Moreover, the tax collected in those years does not show that a sliding scale was in any way a revenue producing factor. In the light of this experience it is therefore highly doubtful that the bill will raise $240 million taxes by introducing class A and class B capital gains.

There is, in my mind, only one way to stimulate capital mobility. It can be done by using the "rollover" approach. The term "rollover" means that transfers of capital assets can be made without incurring a capital gain liability as long as the proceeds from the sale or transfer of the asset are reinvested in property of like kind. It should be within the discretion of a taxpayer to defer the tax on capital gains (I would say up to $15,000) if he reinvests this gain in the same taxable period. This gain would be simply deducted from the cost of the reinvested property. The $15,000 rollover could be recaptured in case of death by simply reporting this gain in the taxpayer's last return provided the taxpayer took advantage of this rollover 3 years prior to his death.

I do not think that the proposed indefinite deduction of $1,000 against income will prove to be of any help in administering the income tax laws. It will make it necessary to preserve records indefinitely. We can visualize cases where the records of transactions resulting in deductible loss would have to be kept for a lifetime. For this reason, I would recommend to double the present deductions of $1,000 against ordinary income for 5 years and thus have things pretty much as they are.

The capital gain problem has been studied by many congressional committees in the past. Many proposals have been advanced and it seems that none of them comes close to an ideal solution. I think that section 219 if enacted will prove to be a decisive liability in any respect. It will be better to postpone any

legislative action on capital gains at this time than to enact provisions which have failed to be of any value in the past.

I do not think that this section would be more digestible if it would be backed up, as the Treasury recommended, by a tax on capital gains at time of transfer by gift or death. This proposal contradicts the principle of realization which is the basis of our present capital gain taxation and which places the taxable event plainly within the discretion of the taxpayer. A tax at time of death or gift would force the taxpayer to take an action he does not want to take and never wanted to take. It would force his heir to partly liquidate an estate in order to pay taxes. It would be a new form of confiscation.

SECTION 220

New and formidable complications would be added to the code by the proposed section 220 of the House bill. A recapture of depreciation on real estate transactions wants to prevent the conversion of ordinary income into capital gain by taxing so-called excess depreciation. This excess depreciation represents the difference of depreciation taken under the straight-line and the double declining method of depreciation. Both methods are permissible under the code, but they result in deductions which are larger under the double declining method in the first years of ownership. If the property is sold in those first few years, there is a larger capital gain for the taxpayer as if he would have used the simple straight-line method.

If it is felt that the use of the declining method results in an undue advantage for the taxpayer, it would be technically much simpler to decree that buildings could only be depreciated by the straight-line method.

Any recapture provision is to be taken with a grain of salt, especially if the final results for the Treasury are simply negligible. Section 220 would add a mere $15 million according to estimates provided by the House Ways and Means report. The question is why give the taxpayer an advantage in the first place if it is taken away from him at a later date?

All recapture provisions complicate the law beyond any reasonable limits. Section 220 will be a nightmare to a practitioner. It can add as much as a dozen computations to the numerous computations of a present-day tax return.

In view of these complications and in view of a changing real estate market, it is recommended not to enact section 220 of the proposed bill.

CHANGES IN THE ADMINISTRATION OF THE CODE

Taxes can be made bearable only if the interpretation of the laws is uniform, if doubts about this interpretation are removed swiftly and efficiently, and if the division of legislative, executive, and judical power is observed is our tax system.

Improvements that could be made in this respect are outlined in the following article which appeared in March 1963. It includes a recommendation to establish an independent body for promulgation of regulations and rulings. Bill S 1872 fulfills these requirements by introducing the concept of a Federal Tax Commission. The adoption of this bill and other proposals made in this article is strongly recommended.

[Reprinted from the March 1963 issue of Taxes—The Tax Magazine]

BLUEPRINT OF A FAIR TAX ADMINISTRATION

(By Arno Herzberg)[1]

The talk about tax reform has been loud and challenging, but almost everybody, from the President down, has a different concept what such a reform might entail. Most of the interested spokesmen have concentrated on rate; many have come out against the complexities of the law, but nobody has said anything about the fact that any stimulant of economic forces that might come from a revised law has to be based on a fair administration and execution of the tax laws. This administration has to take into consideration the overwhelming truth that the burden of taxes on the economy can be made bearable only if the interpretation of the law is uniform, if doubts about this interpretation are removed swiftly and efficiently, if the most fundamental principle of our

[1] The author is a CPA with offices in Newark, N.J.

constitutional system—the division of legislative, executive, and judicial power—is observed within our tax system.

Several concepts have crept into the administration of our tax laws which are completely alien to our democratic form of government. These concepts have, in turn, led to misconceptions and the complexity of our tax laws is profoundly matched by the complexities of their administration.

MISCONCEPTION NO. 1

The Commissioner and the Treasury Department have the right and the duty to protect the revenue. This is undoubtedly true. But this concept has been expended to such a degree that in practice every doubt is resolved by the Commissioner in favor of the Commissioner. More than that, the Commissioner is permitted to take completely contradictory positions in the same case and he is absolved of any such acrobatics by the principle that he has to protect the revenue.

Recently, an appeal court found this exercise somewhat embarrassing. The words, the fifth circuit court used[2] to describe the position of the Government are most revealing. "We cannot help but comment in passing * * * that the same Government which now asserts that Jones should pay tax on the assigned funds * * * had vigorously opposed Jones for nearly 10 years in another forum, where the Government contended that Jones was not entitled to the amount received. Opposed to Jones every step of the way was the strong arm of the U.S. Government * * *." The same decision refers to the alleged principle that the Commissioner has to protect the revenue which, in turn, leads to the temptation to adopt that course which produces the greater revenue. But the court asserts "That purpose is certainly not the philosophy which Congress reflects generally in the income tax law."[3] The principle that the Commissioner has to protect the revenue has thus to be interpreted in a restrictive manner. Congress should establish by law that the Commissioner cannot take contradictory positions in the same case. Protection of the revenue cannot eradicate the basic principle that the Commissioner has to interpret the laws as Congress wants them to be applied and that he cannot claim a favorite position in court. This means, too, that the Commissioner should not be permitted to raise any new issue in court proceedings that he had not explicitly raised in a brief before the court.

A more objective application of the tax laws would result if regulations would not be written and promulgated by the Secretary of the Treasury (Commissioner), but would be passed after proper presentation by an administrative body which would include representatives of taxpayers and practitioners in addition to those of Congress.

MISCONCEPTION NO. 2

The Commissioner has the right to say that he will or will not follow a decision of the Tax Court or any other appeal court. He is permitted to make a pertinent announcement any time after such a decision has been rendered regardless of the fact that countless practitioners have taken such a decision as a basis for their tax planning. The result is that decisions made by management are either wrong or are not made at all, a fact which surely does not contribute to the wellbeing of our economy. At best, the taxpayer is confronted with the choice either to pay additional taxes or to have to go to court to hear again what the same court said in a previous case. Unnecessary costs and congestion of the courts are the result of a situation which, actually, places the Commissioner above any court in the land. It is hardly possible to reconcile this with our democratic and republican form of government. The Commissioner is judge and prosecutor at the same time, something which is completely alien to our Constitution.

In fact, the public does not need to know that the Commissioner takes an adverse position as far as any court decision is concerned. This can be done by administrative fiat. In a recent tax case in which this writer cited a decision of the Tax Court favorable to his position, he was presented with an order of

[2] *Jones* v. *Commissioner*, 62–2 USTC, par. 9629, 306 F. 2d 292 (CA–5, 1962).
[3] *Patchen* v. *Commissioner*, 58–2 USTC, par. 9733, 258 F. 2d 544.

the Commissioner advising agents to ignore this Tax Court decision, although the Commissioner had abandoned his stand and settled this case in the circuit court.

The Commissioner has not only the right to acquiesce or not to acquiesce to any court decision, but he has the right to change his mind, to replace acquiescence with nonacquiescence or nonacquiescence with acquiescence. The result is somewhat grotesque. Recently[4] the Commissioner withdrew nonacquiescence to a decision and reversed a position he held since 1932. It took 30 years to admit that the Board of Tax Appeals was right in establishing a principle which the Commissioner fought for a whole generation.

During the year 1962 the Commissioner withdrew his acquiescence to nine Tax Court decisions and substituted nonacquiescence although he had adhered to one decision since 1948. In four cases noacquiescence was replaced by acquiescence although the Commissioner had ignored one decision since 1941. The score in 1961 is just as interesting: three nonacquiescences withdrawn, one of which stood since 1936; acquiescence was revoked in one case changing the Commissioner's position he had held since 1949. How many cases might have been closed during all those years where the taxpayer submitted to these nonacquiescences.

The complications a practitioner has to face are still better illustrated by the case of *Wilkin* v. *Commissioner* (62-1 USTC par. 9159, 298 F. 2d 893). This decision was rendered by the ninth circuit court on December 26, 1961. Almost 1 year later, on November 14, 1962, a press release indicated that the Commissioner would not abide by this decision. This was made official in IRB 62-53 issued December 31, 1962, in Revenue Ruling 62-214. The closing words of this ruling are most revealing. "Although there was no basis for requesting certiorari of the Supreme Court of the United States and certiorari was not applied for, the decision will not be followed by the Service as a precedent in the disposition of similar cases pending further judicial test of the Treasury regulations." It took 1 year to announce this ruling, but nothing is said about what will happen to all those taxpayers who followed the decision of the ninth circuit court.

Actually, there is no need for a procedure which the Commissioner has tried to justify with the fact that, sometimes, even the courts can be made to change their attitudes. The question is simply this: What is more important—the sure knowledge that the taxpayer has a precedent in a court decision and can, therefore, act in accordance with it or the chance that a court might follow the Government's point of view if pressed hard enough over the next decade. We do not need courts in tax cases if Government and taxpayer are not principally on the same footing subject to the same rights and duties. "The strong arm of the U.S. Government" should not be applied in a manner that makes a mockery of the courts.

The problem can be solved in a simple manner. If the Commissioner is not satisfied with a Tax Court decision, he has to appeal it. If he does not appeal, he has to follow it in all cases. If he is not satisfied with an appeal court's decision, he has to bring it before the Supreme Court or he is bound by it in the future.

Naturally, the old question might be raised whether the present court setup for tax cases is not antiquated.[5] In other countries tax cases have been taken out of the ordinary courts and separate courts have been established which can act more speedily and with more intimate knowledge of economic facts. This does not mean that we condemn everything our ordinary courts have done. On the contrary, many admirable decisions have been rendered, especially by our appeal courts and the reader of these decisions is always impressed by the painstaking research that went into these decisions. But at the same time, we should be aware that a jury can hardly have the knowledge to answer whether a transaction, for example, involves a capital asset or not, and we should be aware that decisions of any court are today rendered by men for whom the tax laws are nothing but one item in a variety of laws. We should be aware of the fact that tax laws cannot always be interpreted in the manner as other laws. It is significant that many courts are baffled by transactions that defy the ordinary rules of contracts and that were not in the law books 10 or 20 years ago. Even the Supreme Court had extraordinary difficulty in comprehending that some of these "new" transactions cannot be put in the straitjacket of traditional law terms.

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[4] See Rev. Rul. 62-160 (IRB 1962-40, 18); Announcement IRB 1962-40 at p. 6.
[5] Arno Herzberg, "Saving Taxes Through Capital Gains," Englewood Cliffs, 1957, p. 418.

CONCLUSION

The public would be served better if all tax cases would be handled by two kinds of courts only—by a Tax Court and by a Court of Tax Appeals. Both courts should be independent and not quasi-administrative bodies. The courts should have enough judges to handle cases speedily and efficiently. The present number of judges for the Tax Court should be doubled. The Court of Tax Appeals should be divided in sections that sit in different parts of the country. If one judge of these two courts wants to deviate from a principle established by a previous decision, the entire court should render a verdict. This would acknowledge the indispensable necessity that a uniform interpretation of the tax laws is more important than the Commissioner's insistence that he has to protect the revenue. If tax laws are supposed to be a drag on the economy, everything should be done to offset the compounding effects of procedures that hamper a fair administration of our tax laws, reduce planning to guesswork or a lottery, and stand in the way of many actions which could contribute to the prosperity of our country.

LLOYD CORP., LTD.,
Beverly Hills, Calif., December 5, 1963.

Re Section 216 of H.R. 8363, taxation of personal holding companies, Revenue Act of 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: The purpose of this letter is to call to the attention of your committee the drastic effect of H.R. 8363 in connection with our business operations. Previously we had endeavored to secure permission from the clerk of the committee to appear and testify in person but were advised that the requests for permission to testify before your committee were so numerous that we could not be accommodated. In this letter, I propose to set out the salient facts concerning our company and illustrate what we hope is the unintended effect of H.R. 8363 on a closely held operating business.

For many years, Lloyd Corp., Ltd., has been engaged in extensive oil operations consisting of the actual drilling and production of oil on acreage owned by it for a number of years. In 1962, this oil production which produced operating income of approximately $3½ million amounted to 985,000 barrels. Incidental to its drilling operations, the company has oil royalty income of a substantial amount. Aside from home office employees, there are 36 persons employed in connection with its oil operations. Of some 680 independent producers in the State of California, it ranks 18th in volume. During the past 5 years, it has engaged in the development, construction, and operation of large shopping center on land, the bulk of which it had owned for more than 30 years, borrowing approximately $25 million for this purpose, upon which indebtedness it is obligated to make principal payments in the area of $1 million per year for many years in the future.

The rental income from this real estate is anything but passive. The payroll for services rendered in conection with said shopping center—for office, public relations, maintenance, police staff, property maintenance and boiler room, gardeners, outdoor sweepers and repairmen, janitors, and ice rink employees—total approximately $450,000 per year, and other operating expenses in this connection (exclusive of depreciation, property taxes, and interst) approximate an additional $200,000 per year. Our dividend and interest income are insignificant, and obviously, therefore, neither our rental income nor our mineral royalty income is sheltering any significant dividend or interest income. In fact, our interest income results principally from loans made to tenants in the shopping center. The company has regularly paid substantial taxable cash dividends to its shareholders.

Under existing law, Lloyd Corp., Ltd., is not a personal holding company because rents from the shopping center constitute more than 50 percent of its gross income. Under existing law, its income from dividends, interest and oil royalties is approximately 16 percent of gross income. Even without regard to the classification of rent as nonpersonal holding income, the company's gross income from oil and gas operations exceeds 20 percent of its gross income. However, under the provisions of H.R. 8363, our rental income from the shopping center would be reduced to a point where it would amount to only approximately 26 percent

of the adjusted gross income and Lloyd Corp. Ltd., would be classified as a personal holding company and subject to a heavy tax burden.

It is submitted that the new mechanical 50-percent test for determining personal holding company income from rents as set forth in section 216(d) of H.R. 8363 does not reflect the difference between active rental income and passive rental income. This is particularly true in the case of Lloyd Corp., Ltd., because it has a substantial amount of other operating business income.

As stated earlier, Lloyd Corp., Lta., is engaged in at least two active businessess. It presently employs 212 people and has an annual payroll in excess of $1 million. The shopping center alone employs 117 persons. While the rental income shown on the attached exhibit is principally from the shopping center, Lloyd Corp., Ltd., has other real estate investments and this department has 36 employees with a payroll of $160,000. It is submitted that any business or businesses which have a payroll of the dollar volume of Lloyd Corp., Ltd., is not the passive investor-type operation or shelter-type operation which the Treasury Department must have had in mind when recommending changes in this area.

The loophole contemplated by the Treasury Department appears to be that it is possible under existing law for passive investment income such as dividends and interest to be sheltered by operating income of a relatively small amount. We believe the objectives of the Treasury Department could be accomplished by drawing a distinction between active rental income and passive rental income so that corporations owning and renting out real estate and serving merely as a collection agency would be placed in a different category than corporations which have a substantial business operation as illustrated by a substantial number of employees and which are engaged in a real business activity. Rental income which is produced as the result of an active business operation should not be treated as personal holding income for any purpose. This has precedent in existing law in the regulations issued pursuant to section 355.

Another suggested change would give operating businesses an escape hatch from the harsh personal holding provisions of H.R. 8363. The adjustments to the gross income from working interests in oil and gas wells at outlined in proposed section 543(b)(2)(B) should be restricted to purchased working interests and not those which are developed and operated by the taxpayer. According to Secretary Dillon, one of the abuses in this area is the purchase of a working interest to shelter passive investment income with the cost depletion offsetting most of the income from the oil or gas interest. There is no more reason to single out the active developer of an oil or gas operation for these adjustments to gross income than there would be to apply it to a manufacturer. Certainly, corporations engaged in developing and producing oil and gas wells on their own property fall into a different category than the incorporated pocketbook, which buys the working interest in an oil and gas property after development to shelter substantial amounts of investment income.

If the committee is disposed to adopt the rigid mechanical formula contained in the House bill without attempting to determine the true nature of the business activity which produces the income, the following solution might be of help. This could be accomplished by consolidating adjusted income from rents and adjusted income from royalties in applying the 50-percent and 10-percent tests contained in proposed sections 543 (a) (2) and (3) or by consolidating adjusted income from royalties with adjusted income from oil operations in applying the 50-percent test and at the same time exclude active rental income from the 10-percent test. The adoption of this proposal would eliminate any question of Lloyd Corp., Ltd., from being a personal holding company since its passive investment income of dividends and interest is slightly more than 5 percent of adjusted gross income as defined in section 216 of H.R. 8363.

The adoption of this modification of the mechanical tests contained in section 216 of H.R. 8363 would prevent the personal holding company classification of many corporations which derive substantially all their income from the active conduct of more than one business. This type of corporation is not a closely held investment company which derives most if not all of its income from passive investments and which has an office force of one or two persons. As indicated previously, under existing law, Lloyd Corp., Ltd., had approximately 16 percent of its gross income classified as personal holding company income. Under the rigid mechanical formula of H.R. 8363 the percentage of personal holding company income increases to 65 percent. It is submitted that the sweeping approach suggested in the House bill should be reexamined by this committee so that

legitimate operating business conducted in the corporate form by a relatively small number of shareholders will not be taxed as an investment company.

The relief provisions allowing liquidation in H.R. 8363 are inadequate. They are proper for passive investment companies which are looking for an opportunity to liquidate without too heavy a tax. However, they are no solution to a company such as Lloyd Corp., Ltd., which is actively engaged in two businesses and is constantly looking for new business ventures. Furthermore, because of pending litigation involving the determination of substantial oil income of Lloyd Corp., Ltd., that is, whether it is operating income or royalty income, Lloyd Corp., Ltd., may not qualify for any relief whatsoever. Because of the large indebtedness owed on the shopping center, a reorganization of the business under section 355 is not practical.

Inasmuch as the revenue impact of the proposal is relatively minor in considering the overall aspect of the bill, perhaps the best solution would be to have the entire section of the bill dealing with the personal holding companies referred to the staff of the Joint Committee on Internal Revenue Taxation for further study. It is inconceivable that the Treasury staff and the staff of the Joint Committee on Internal Revenue Taxation could not come up with a solution to the evils described by Secretary Dillon and yet one which would not interfere with the normal operating business routine.

Respectfully submitted.

DAVID W. YULE,
Treasurer, Lloyd Corp., Ltd.

SCHEDULE A

	Nonpersonal holding company income		Personal holding company income				Total
	Oil receipts	Ice rink receipts	Rents	Oil royalties	Dividends	Interest	
Under proposed law:							
1962 income	[1] $1,940,830	$211,819	$4,316,248	$1,185,822	$93,543	$81,662	
Less adjustments required by proposed law, depreciation, depletion, taxes, and interest	[2] 1,469,390		[2] 4,921,073	[2] 350,053			
Net income	471,440	211,819	0	835,769	93,543	81,662	$1,694,233
Percentage	27.8	12.5		49.3	5.52	4.88	
1963 estimated income	[1] $1,500,000	$220,000	$4,525,000	$1,045,000	$45,000	$55,000	
Less adjustments required by proposed law, depreciation, depletion, taxes, and interest	[3] 1,079,000		[3] 4,000,000	[3] 280,000			
Net income	421,000	220,000	525,000	765,000	45,000	55,000	$2,031,000
Percentage	20.73	10.83	25.85	37.67	2.22	2.70	
Under present law:							
1963 estimated income	[1] $1,500,000	$220,000	$4,525,000	$1,045,000	$45,000	$55,000	$7,390,000
Percentage	20.30	2.98	61.23	14.14	0.61	0.74	

[1] After deducting costs of production.
[2] Per 1962 return.
[3] Per 1963 proposed return, figures estimated.

TAX SECTION, NEW YORK STATE BAR ASSOCIATION

REPORT ON THE REVENUE BILL OF 1963, H.R. 8363, AS ADOPTED BY THE HOUSE OF REPRESENTATIVES ON SEPTEMBER 25, 1963

NOVEMBER 29, 1963.

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

There follows a report of the tax section of the New York State Bar Association on various sections of H.R. 8363, the revenue bill of 1963, as adopted by the House of Representatives on September 25, 1963. Each of the several divisions of this report was the work of one of the committees of the section as identified at the beginning of the division. The entire report represents the views of the tax section as a whole through action of its governing body, its executive committee.

The committees of the tax section have reviewed all sections of H.R. 8363. The provisions of the bill which have been commented on in this report present technical questions on which the tax section committees felt they could best contribute through their particular experience. The absence of comment in the report on other sections of H.R. 8363 is not intended to indicate either approval or disapproval of those provisions of the bill.

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REPORT ON THE FOLLOWING SECTIONS OF THE REVENUE BILL OF 1963, H.R. 8363

Section 122. Current taxpayments by corporations.
Section 214. Employee stock options and purchase plans.
Section 216. Personal holding companies.

CORPORATE TAX COMMITTEE

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Section 122. Current taxpayments by corporations

The provisions of section 122 will place corporate taxpayments on a fully current basis over a period of years. It is recommended that the fourth payment date be shifted from the 15th day of the 12th month of the taxable year to the 15th day of the 1st month succeeding the taxable year. This would permit corporations to estimate fourth quarter income and yearend adjustments on a much sounder basis. The rule would then be in accord with the rule for individuals (sec. 6073, code). It would mean the shift of the fourth payment date from December 15 to January 15, for calendar year corporations.

Section 214. Employee stock options and purchase plans

(1) Section 214 of H.R. 8363 creates three categories of stock options: restricted stock options, qualified stock options, and employee stock purchase plans.

As under section 421(f) of the present law, proposed section 421(b) provides that any increase in the optionee's income, and corresponding deduction by the grantor corporation, arising out of a failure to meet the holding periods specified by the pertinent substantive section, is treated as occurring in the year of disposition.

In the case of qualified stock options, a "relief" provision has been included (sec. 422(c)(4)) under which the ordinary income taxed to the optionee is limited to the amount of actual gain realized. This relief provision is not made available in the case of disqualifying dispositions of stock acquired pursuant to restricted stock options or to employee stock purchase plans; in such cases, if the gain actually realized upon disposition failed to equal the amount of ordinary income reportable as a result of the disqualifying disposition, a capital loss would be allowed. (See H. Rept., p. 69.) No policy reason is discernible for this distinction. It is recommended the distinction be eliminated.

(2) Sections 422(a)(2), 423(a)(2), and 424(a)(2) utilize the definitions of "parent" and "subsidiary" contained in section 425 (e) and (f). A question has been encountered under present law, i.e., whether an option granted by a subsidiary to its employee to purchase stock of the parent corporation continues to qualify for favorable treatment if the subsidiary-parent relationship ceases to exist and the employee exercises his option more than 3 months after he has transferred from the grantor corporation to its former parent. Section 425 (e) and (f) provides that the determination as to the existence of a parent-subsidiary relationship is to be made at the time of the granting of the option, as do the provisions of section 421(d) (2) and (3) of present law. While this principle is stated in Reg. Sec. 1.421-3(c)(1), considerable confusion and uncertainty has been created by the statement in Reg. Sec. 1.421-3(b)(1) that "Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is *at the time the option is exercised* a parent or subsidiary of such corporation" [emphasis added], unless the limited provision in section 421(g) for certain corporate transactions is satis-

fied. Some provision should be made to preclude the utilization of H.R. 8363 by the Commissioner to support the validity of the position taken in Reg. Sec. 1.421-3(b)(1) under the "reenactment doctrine." (See *Cammarano v. United States* (358 U.S. 498, 510-511 (1959)).

(3) Section 423(b)(8) would limit to a rate of $25,000 per year the amount of stock that an individual employee might purchase under a qualifying employee stock purchase plan. While there appear to be no technical objections to this provision, question is raised that the $25,000 limitation is unnecessary and would be productive of arbitrary results. Section 423(b) in overall terms precludes discrimination in favor of the more highly compensated employee. It is recommended that the dollar limitation be removed.

(4) By far the most important of the stock option changes incorporated into the bill appear in proposed section 422(b). In view of the evolution of these provisions (the Ways and Means Committee was making changes in its "tentative decisions" right up to the introduction of the bill—and additional amendments may well be effected before enactment), we believe that the effective date should not be set prior to the solidification of the legislative intent. It is our recommendation that any effective date in section 422 should be set "upon the date this act becomes law." Alternatively, it is recommended that section 425(h)(3) be expanded to permit modification, within a stated period (say, at least 1 year) after the enactment of the act or January 1, 1965, whichever is later, of options that had been granted from June 12, 1963 and prior to enactment, to conform such options to the requirements of the act.

Many existing plans which were approved by stockholders within 12 months after adoption expressly provide that the plan may be amended (with specified exceptions) by the directors alone. If section 214 of the bill is enacted into law, most if not all of such plans will have to be amended so as to conform the options issued thereunder to the new rules. We do not believe that the Congress intends to require stockholders approval for amendments designed solely to conform to the new requirements—particularly where such amendments by director action only are expressly authorized in the plan itself. With a view toward avoiding litigation on the point and insuring against an unintended hardship, it is recommended that the point be clarified in the Senate—at least via a statement in the Senate Finance Committee report—to the effect that an amendment of a plan by the directors of a corporation, made within the "makeup period" referred to above, in pursuance of authority expressly granted by the stockholders to such directors, designed solely to qualify the options granted thereunder for the treatment prescribed in section 421 as amended by the act shall not be regarded as the adoption of a new plan for the purposes of sections 422 or 423.

(5) Section 422(b)(5) is really intended to prevent a second option from being exercised at a time when an option, previously granted at a higher price, is outstanding and capable of being exercised. The abuse sought to be corrected is the resetting of the price of such previously granted option, by the device of granting the second option at a lower price and thereby avoiding the "modification" rules of present section 421(e) (H. Rep., p. 68). Since the provision (as now written) would apply even where outstanding options were previously granted at a lower price, a limiting amendment would seem appropirate to bring it in line with the underlying intent.

Furthermore, it is believed that the proper technique to accomplish the desired result would be to move this requirement out of the "option content" provisions of section 422(b) into the operative conditions of section 422(a) by creating a new subsection entitled section 422(a)(3) which would read substantially as follows:

"(3) at the time the option is exercised there is not outstanding (within the meaning of subsection (c)(2)) any qualified stock option (or restricted stock option) which was granted at a higher price and at a time prior to the granting of such option, to such individual to purchase stock in his employer corporation or in a corporation which (at the time of the granting of such option) is a parent or subsidiary corporation of the employer corporation, or in a predecessor corporation of any of such corporation;"

(6) An additional problem is raised by the definition of "outstanding" contained in section 422(c)(2). Consider the situation where a previously granted qualified stock option has unmatured installments outstanding at a time when a second qualified option, granted at a later date, is exercisable. If the present language of section 422(c)(2) is applied, qualified stock option treatment would be denied to the second option. The effect of the definition of "outstanding" in 422(c)(2) is to treat as "exercisable" an option which under its terms may

not be exercisable at the time for determination of "outstanding" options. The unfairness of this treatment was recognized by the committee and relief was extended by means of the last sentence of section 422(c)(2). However, such relief is limited to restricted stock options granted before June 12, 1963. There appears to be no policy supporting discrimination against qualified stock options. For this reason, we recommend that the last sentence of section 422(c)(2) be changed to read:

"For purposes of the preceding sentence, an option shall not be treated as outstanding for any period before the first day on which (under the terms of such option) it may be exercised."

(7) Section 422(a) provides that, in order to secure the benefits of the favorable treatment accorded to qualified stock options, no disposition of the optioned shares may be made within 3 years of the date the shares were acquired.

The timing of events in the development of section 422(a) leads us to question whether the 3-year period is not due to inadvertence on the part of the Ways and Means Committee. The 3-year rule was first announced, in tentative form, on May 29, 1963, 1 day after the committee had tentatively decided to extend from 6 months to 3 years the minimum holding period on long-term capital gains generally. On August 9, 1963, the committee announced a modification of its earlier views on the capital gains holding period, reducing from 3 years to 2 years the minimum holding period for class A long-term capital gain treatment. If (as we suspect) the 3-year holding period in section 422(a) was due to inadvertence, we recommend that it be changed to 2 years.

Section 216. Personal holding companies

(1) Section 216(j)(2) would amend section 1016(a) of the code (relating to basis adjustments) by adding at the end thereof the following new paragraph:

"(21) to the extent provided in section 1022, relating to increase in basis for certain foreign personal holding company holdings, or in section 216(j)(4) of the Revenue Act of 1963."

The reference to "section 216(j)(4)" appears to be a typographical error, and was intended to be to section 216(j)(5) (H. Rep., p. A 119). In fact, it would be preferable if the provisions of section 216(j)(5) were made part of the code by adding them at the end of section 1014.

(2) Section 216(i) allows personal holding companies which become personal holding companies solely by reason of the amendments in this bill to deduct in computing their undistributed personal holding company income amounts used or irrevocably set aside to pay or retire "qualified indebtedness" but only to the extent the aggregate amounts so used or set aside in taxable years beginning after 1962 exceed the aggregate of deductions for exhaustion, wear and tear, obsolescence or amortization and deductions for long-term capital gains (less taxes attributable thereto) allowed for such taxable years. The reason given for this limitation is that such deductions represent accumulated funds which can or should be used by the corporation to pay off its indebtedness in the same manner as its earnings and profits; and, since a deduction is already allowed therefor, no further deduction is warranted for the actual use or setting aside of such funds for that purpose. However, from the wording of the limitation as proposed in section 216(i), it does not appear to be applicable with respect to funds accumulated by the corporation as a result of "depletion" deductions allowed under sections 611 and 613 of the code. Since one of the principal purposes of section 216 of the bill is to close the loophole arising out of the use of mineral interests by personal holding companies, it would seem appropriate that this limitation be equally applicable with respect to such deductions.

REPORT ON THE FOLLOWING SECTIONS OF THE REVENUE BILL OF 1963, H.R. 8363

Section 203. Group-term life insurance purchased for employees.
Section 213. Interest on loans incurred to purchase certain insurance and annuity contracts.

COMMITTEE ON INSURANCE AND ANNUITIES

Martin M. Lore, chairman

Lawrence A. Blatte	Alvin E. Moscowitz
Arthur Norman Field	Donald J. Reap
Edwin M. Jones	Laurence Sovik
C. Emory Lochner	Joseph Trachtman
Stuart McCarthy	Bernard Elber

Section 203. Group-term life insurance purchased for employees

Section 203 would amend the Internal Revenue Code by adding a new section 79. Under this section there would be included in the gross income of an employee an amount equal to the cost of group-term life insurance on the employee's life under a policy or policies carried by his employer or employers, to the extent that such cost exceeds the sum of—

(1) the cost of $30,000 of such insurance protection; and

(2) the amount, if any, paid by the employee.

The cost of such insurance protection is to be determined on the basis of uniform premiums (computed on the basis of 5-year age brackets), prescribed by regulations to be issued by the secretary or his delegate. If, however, the employer elects and certain other conditions are met, such cost can be determined on the basis of the average cost under the policy, using the 5-year age bracket approach.

Section 203 of the proposed act would also amend the law by requiring the withholding of a Federal income tax based upon the amount includible in the gross income of the insured employee by reason of group-term life insurance coverage. In the event the amount paid by the employee for such group-term life insurance coverage is in excess of the amount includible in his gross income under section 79, the employee is permitted to deduct, under the provisions of section 218, such excess in determining his Federal income tax liability.

The general explanation report of the committee on ways and means (p. 40) states that the exclusion with respect to the first $30,000 of insurance protection was provided "* * * because it [the committee] believes, from the standpoint of the economy as a whole, it is desirable to encourage employers to provide life insurance protection for their employees. Provision of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely."

(1) *Thirty-thousand-dollar limit should be raised to $40,000.*—It is believed that a more proper limitation upon the face amount of group-term life insurance coverage provided by employer contributions, without resulting taxable income to the covered employees, would be $40,000. Such a limitation would conform to the overall maximum limit recommended by the National Association of Insurance Commissioners. The laws of 24 States have, in substance, incorporated the limitations on individual coverage recommended by the NAIC and provide an overall $40,000 maximum for group life insurance coverage on any one life. North Carolina provides a flat $40,000 limitation. It would seem that the Federal law should adopt the figure that has been accepted in so many States as being desirable from a public policy viewpoint.

(2) *Elimination of alternative policy cost method and promulgation of realistic national average cost, adjusted by a factor for age.*—It is believed that the alternative "policy cost" method of computing the amount to be taxed to an employee, by quinquennial age brackets, is apt to lead to substantial differences between companies and hence taxpayers by reason of facts peculiar to each individual group case. It is suggested that the alternative "policy cost" calculation by quinquennial ages be eliminated.

In addition, it is suggested that the uniform premium to be prescribed by regulation be an average premium cost for $1,000 of group-term insurance protection adjusted upward or downward by a factor to reflect the age of the insured, and that such average premium cost be based upon current figures supplied by insurance companies to the Government.

(3) *Clarification of tax consequences where coverage is provided for only part of the taxable year.*—Under the present provisions of proposed section 203, there is no specific indication that insurance protection for only a part of a taxable year will result in only a proportionate part of the appropriate full-year "cost" being includible in the insured employee's gross income, except if the employee terminates his employment and has either reached retirement age, or is disabled, within the meaning of section 213(g). To the contrary, unless the limited retirement or disability exception applies, it would seem that the full cost, under the uniform premium table method (unless the employer elects the alternative policy cost method), would be includible in the gross income of the employee, even though he may have coverage for only a few weeks during the taxable year. This could result upon his being employed in the last few days of a taxable year, or having his insurance coverage terminated in the beginning of the taxable year, other than by reason of retirement or disability.

In order to rectify this apparent inequity, it is suggested that an additional subsection be added to the proposed law to provide specifically that in the event that coverage is only provided for a part of a taxable year, the amount includible in the gross income of the employee shall be equal to that part of the full year's cost as the period he is covered by such insurance bears to the entire taxable year.

(4) *Clarification of meaning of "retirement age".*—Under the proposed law, once an employee terminates his employment and has either reached "retirement age" or is disabled, the cost of group term life insurance protection is no longer includible in his gross income. Unfortunately, the proposed law does not define "retirement age" for this purpose. The Technical Explanation Report of the Committee on Ways and Means (p. A 31) indicates that the determination of "retirement age" is to be made in the same manner as is now applicable under sec. 105(d) of the code with respect to wage continuation plans.

The meaning of the term "retirement age" for purposes of section 105(d) is far from clear at this time. In addition to the issuance of detailed regulations in this area, the Service has issued two specific rulings to help resolve the problems introduced by using the term "retirement age," without a statutory definition of the term. The first ruling, Revenue Ruling 57-76, 1957-1 C.B. 66, was modified by the Service itself, by the issuance of Revenue Ruling 61-6, 1961-1 C.B. 15. Moreover, even with these regulations and rulings outstanding, the matter is still the subject of litigation. (See *Comm'r.* v. *Winter et al.*, 303 F. 2d 150 (3d Cir. 1962) affirming 36 T.C. 14, to which the Internal Revenue Service nonacquiesced at 1962-2 C.B. 14.)

Rather than subject the taxation of group term insurance premiums to the uncertainties which now exist under section 105(d), it is suggested that section 203 of the proposed act incorporate a specific definition of "retirement age."

Section 213. Interest on loans incurred to purchase certain insurance and annuity contracts

Section 213 of the revenue bill of 1963 would amend section 264 of the Internal Revenue Code by disallowing as an interest deduction interest paid or accrued on a loan incurred pursuant to a plan of purchase which contemplates the systematic borrowing of the increase in the cash value of the contract, except under certain circumstances.

(1) *Elimination of possible ambiguity regarding beginning date of 7-year period.*—The first exception provides that the disallowance of the interest deduction will not result "if no part of four of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness." The committee reports indicate that the period of 7 years is to run from the "date of purchase" of the contract. It is noted that "purchase" (which is a term that is also used in the proposed new paragraph 3 to be added to section 264(a)) might be interpreted to relate to a purchase from any party, and not only from the issuing insurance company. Accordingly, there may exist an unintended ambiguity regarding the time when the 7-year period begins to run. For example, the "first premium" might be considered as meaning the first premium after purchase from a third party, and not from issuance of the contract. Any such ambiguity seems obviously unintended. Accordingly, it is suggested that the language be clarified to make it entirely clear that the 7-year period begins to run from the date of issuance of the contract in question.

(2) *Elimination of "annual".*—It is noted that the first exception refers to "annual premiums." Policies frequently contain no reference to an annual premium. It is suggested that the word "annual" be deleted in order to avoid any possible ambiguity as to the application of the exception to a monthly, quarterly or semiannual premium paying policy.

(3) *Elimination of "unforeseen".*—Another exception relates to indebtedness incurred because of "unforeseen substantial loss of income" by the taxpayer or the "unforeseen substantial increase" in his financial obligations. Apparently, two tests must be met by the taxpayer. He must be able to show "unforeseen loss of income" or "unforeseen" increases in financial obligations as well as "substantial" loss of income or increased obligations.

The interpretation of "substantial" in taxing statutes has always been troublesome. The interpretation of "unforeseen" will be even more troublesome. It introduces a subjective test with respect to which proof may be practically impossible. Each "plan" will have to be examined on its own particular facts or allegations. The taxpayer who intends to manipulate the interest deduction will

be careful to avoid creation of any record that might evidence foreseeability. It is suggested that consideration be given to elimination of the "unforeseen" test and, since relief during the first 7 years is all that is needed, to having this exception refer only to a substantial loss of income or increase in obligations during the initial 7-year period after issuance of the policy with respect to which the loan is made.

REPORT ON THE FOLLOWING SECTIONS OF THE REVENUE BILL OF 1968, H.R. 8363

Section. 206. Exclusion from gross income of gain on sale or exchange of residence of individual who has attained age 65.
Section 207. Denial of deductions for certain State, local, and foreign taxes.
Section 212. Moving expenses.
Section 215. Interest on certain deferred payments.
Section 221. Income averaging.

COMMITTEE ON PERSONAL INCOME TAX

John W. Fager, Chairman

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Section 206. Exclusion from gross income of gain on sale or exchange of residence of individual who has attained age 65

Section 206 of the bill provides for a new section 121 of the code, which contains a complete exclusion from tax of the profit from the sale of a residence for $20,000 or less in the case of a taxpayer 65 years or older and a proportionate exclusion from tax where such sales price is over $20,000.

The tax section feels this new exclusion represents one more complication in a tax law which is crying for simplification. Once exclusion was allowed in the case of the sale and repurchase of another residence within 1 year (sec. 1034), it can be argued that no gain should be recognized, in certain cases, even though no reinvestment occurs. But does this follow? Section 1034 really is based on a form of involuntary conversion; i.e., an employee is required to move from one part of the country to another.

If the new section 121 is a logical outgrowth from section 1034, then there is no logic to limiting it to persons 65 or older. If a person under 65 has to sell his residence and move into rented quarters because of ill health, business reverses or any other reason, why should he be treated differently? The ultimate logic may be to exempt gains on the sale of a personal residence up to a prescribed maximum just as, under present law, no loss on the sale of a personal residence is recognized.

Accordingly, we recommend that the present section 1034 and the proposed new section 121 be rolled into a simple section exempting from tax gains (up to a prescribed maximum) on the sale of a personal residence, with appropriate safeguards to prevent tax avoidance in case of builders, dealers, etc. The latter would simplify rather than complicate the tax law and achieve equity, rather than creating one more exclusion favoring a small group of taxpayers.

Section 207. Denial of deduction for certain State, local, and foreign taxes

Section 207 of H.R. 8363 amends section 164 of the code to allow as deductions state, local and foreign real property, income, war profits and excess profits taxes and state and local personal property and general sales and use taxes. Other taxes are deductible only if they constitute expenses of carrying on business or of collecting income.

A personal property tax must be an "ad valorem tax which is imposed on an annual basis." The Ohio personal property tax is imposed on a yield rather than a market value basis, which raises the question of whether it is an ad valorem tax. Some jurisdictions impose a personal property tax as of a date

fixed by the taxing authority. If more than 12 months elapses between two such dates, the tax may not be imposed on an annual basis. The statute does not define a real property tax, although it would seem desirable to do so. The definition of both real and personal property taxes should include not only ad valorem taxes, but taxes imposed in lieu thereof and annual either should be omitted or changed to periodic.

For a sales tax to be deductible it must be imposed at one rate in respect of the sale at retail of a broad range of classes of items. Section 164(b)(2) provides, however, that the application of lower rates to, or the grant of an exemption to, "food, clothing, medical supplies, and motor vehicles" will not prevent deductibility. This provision raises the inference that the application of a lower rate to, or the grant of exemption to, any other item will render sales tax nondeductible. The New York City sales tax exempts papers and periodicals and cigarettes, the latter because a special tax is imposed. Similar problems may arise as to liquor or gasoline which often are subjected to special taxes. What is essentially a general sales tax should not be disallowed because it grants an exemption to, or taxes at a lower rate, a few items not listed in section 162(b)(2)(B). The bill should be amended to avoid such a result.

Section 212. Moving expenses

Section 212 of the bill amends the code to provide a new section 217, covering a deduction for certain moving expenses of an employee.

We agree with the objective underlying this amendment.

The tax section feels, however, that the amendment adds another complication to the code in that it creates one tax rule for new employees and a different rule for current employees, since it continues the present rule that reimbursement of the moving expenses of a current employee is excludible from gross income (with no deduction of course allowed). See section 217(e).

We recommend that all moving expenses of employees of the nature involved here be treated alike for tax purposes, in the interest of simplicity of administration. Taxpayers and persons preparing tax returns should not be confused as between a deduction and an exclusion. The tax section recommends that all such moving expenses be treated as deductions with the corollary rule that all reimbursement of such expenses be deemed to be income to the employee.

Section 215. Interest on certain deferred payments

Section 215 of the bill adds a new section 483 to the code, providing for the taxation as interest of portions of deferred payments in the case of sale or exchange of property.

The tax section recommends that section 483 be amended to clarify its application to the installment sales provisions of the code (sec. 453).

Payments indefinite as to time, liability or amount, are covered. A separate determination is made as to such portion as of the payment date as if it were the only payment. We do not think section 483 should be applied to payments indefinite as to liability or amount, since in many or most of such cases the parties do not contemplate an interest factor.

The tax section also recommends that a seller be given the opportunity to prove that the selling price did not exceed the fair market value of the property, in which case there would be no constructive interest under section 483.

The new provisions apply to payments made after December 31, 1963, under sales occurring after June 30, 1963. Should there be a June 30 cutoff date? The measure was described by Secretary Dillon in his February statement proposing a February 6 cutoff. The bill was reported to the House in September. The tax section urges that this new section not be applied to sales entered into prior to the enactment of the new tax law, in view of the fact that parties have contracted while passage of the bill was in doubt, and the House report states that the effect of this section on the revenue will be negligible.

Section 211. Income averaging

This is one of the most important and most complicated of the provisions of H.R. 8363. It prospectively repeals sections 1301-1307 of the code and replaces them with one new method of averaging, applicable to all taxpayers.

The tax section approves in principle this approach as an improvement over the existing sections, which afford limited and varying relief to limited groups of taxpayers. Many methods of general income averaging have been advocated over the years, most of them too complicated to be understood by taxpayers or tax agents.

We feel the proposal contained in section 221 is, in principle, workable, but that the Senate should attempt to simplify it by eliminating some of the special rules applicable to but few taxpayers.

Specifically we feel many of the complicated rules with respect to capital gains in the 4 base period years and in the current tax years are difficult to understand or apply and will be of only marginal application in any event. None of the existing sections (1301-1307) contain any specific rules for the separate treatment of capital gains and losses.

Specifically we recommend that section 1302(a)(2) be deleted. This requires the reduction of "averagable" income in the computation year where average base period capital gain net income exceeds the capital gain net income for the computation year. While in theory there is some foundation for such a reduction, it is considered unlikely to be of any application in 99 out of 100 cases, and, in any event not worth the complications it entails.

We also recommend that section 1302 be amended to make it clear how a loss year in the base period is to be handled. We suggest it be averaged in as a loss (not as zero).

Unless section 221 can be simplified, we are afraid that administration of the new averaging provisions will be extremely difficult, both from the point of view of the tax payer and the Internal Revenue Service.

Finally, we recommend that the option to choose between the existing code provisions and the new averaging provisions, in the case of section 1301 cases, be extended to include section 1302. The House provided that, in the case of an employment which began before February 6, 1963, the taxpayer could elect to use the provisions of the present section 1301 instead of the new provisions. Authors and others eligible to use the present section 1302 should be given this election to use it in the case of work commenced before February 6, 1963.

(Whereupon, at 12:50 p.m., the committee recessed to reconvene at 10 a.m., Tuesday, December 3, 1963.)

REVENUE ACT OF 1963

TUESDAY, DECEMBER 3, 1963

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 (chairman) presiding.

Present: Senator Byrd (presiding), Douglas, Gore, Ribicoff, Williams, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. William F. Hellmuth, dean of Oberlin College.

Take a seat. Very glad to see you here, sir.

STATEMENT OF WILLIAM F. HELLMUTH, DEAN, COLLEGE OF ARTS AND SCIENCES, AND PROFESSOR OF ECONOMICS, OBERLIN COLLEGE

Mr. HELLMUTH. Mr. Chairman, members of the committee, thank you for the opportunity to appear before the Committee on Finance to testify on H.R. 8363.

This bill, with a record amount of tax reduction and other important features, will be one of the landmark acts in the 50-year history of the Federal income tax.

Let me summarize my major points briefly at the start.

1. I support the Revenue Act of 1963 in general, and recommend that it be enacted.

The American economy needs the stimulus of a strongly expansionist economic policy by the Federal Government. Fiscal policy is probably the most effective way to promote greater economic activity and thereby reduce the excessively high and persistent unemployment level and to raise the lagging growth rate. The sizable tax reduction in this bill of about $11 billion annually will be a major and much needed stimulant to the lagging economy.

2. A requirement that the Federal spending be cut to accompany the tax cut would be unfortunate in that it would dilute the stimulus of the tax reduction.

A reduction in Federal spending would offset or cancel the expansionist effect of the tax reduction, the extent depending on the relative amounts. A reduction in Government spending reduces aggregate demand, while tax reduction by increasing after tax incomes of individuals and corporations will tend to increase aggregate demand.

Of course, the Federal Government should always be prudent and thrifty in its spending. It does face large and growing responsibilities. It should always perform its functions as efficiently and as economically as possible. If it does become possible and desirable to reduce Federal spending while meeting all of its responsibilities, I would applaud the reduction. With economic expansion the present goal, however, any reduction in Government spending should be paired with an increase in the size of the tax cut to achieve the same net stimulant to the economy. The economy may also need some increase in certain Federal programs as part of a comprehensive and effective attack to reduce unemployment and promote economic growth. A commitment to reduce or freeze Federal spending might make such programs impossible.

3. I recommend that certain key provisions in H.R. 8363 be revised to include more tax reform and to adhere more closely to a progressive tax system.

The revisions I will suggest will do much to make the revised income tax equitable, to permit ever greater reductions in tax rates, to improve the allocation of resources, to minimize tax considerations in private economic decisions, and to strengthen the incentives and the means to create more jobs and achieve a higher rate of economic growth.

There is a fear of a shift in the bill from emphasis on income taxes based on ability to pay to emphasis on other taxes which are regressive. Or I might highlight these last two points, that the concern which some have is the possibility that the expansionist effect may be lost or heavily diluted by cuts in spending, that needed programs will not be adequately supported, and that the only major progressive taxes in our national tax system will be deemphasized.

Let me try to develop each of these three points briefly.

First, the need for tax reduction to promote economic expansion. The economy is presently setting new levels by many different economic measures.

Senator GORE. Mr. Chairman, I have looked over this paper. I think it is one of the most important that I have seen come before the committee.

Senator DOUGLAS. I think I would like to suggest the witness be given full time to develop his points.

The CHAIRMAN. Proceed, sir. Whatever time is necessary.

Senator GORE. You were generous in suggesting the limitation but I have examined your paper and I think it is worthy of full consideration.

Mr. HELLMUTH. Thank you.

Senator GORE. I wouldn't suggest I think more of it than you do.

The CHAIRMAN. Do you want to start at the beginning of your paper?

Mr. HELLMUTH. Let me proceed.

1. Tax reduction needed to promote economic expansion: The American economy currently is setting new records in total employment, personal income, gross national product, corporate profits, stock market prices, and automobile output. The wholesale price index is no higher than it was 5 years ago and the Consumer Price Index has increased only about 1½ percent a year over the same period. The economy generally is more prosperous than it has ever been.

Senator GORE. Mr. Chairman, could I break in there just a moment——

The CHAIRMAN. Senator Gore.

Senator GORE (continuing). To add further emphasis to the paragraph which you have just read. I just listened to Dr. Heller on a television program and he said that proposed capital outlays of business for next year were at an alltime high and that we were on the verge—I think he added that perhaps we just might already be there—of a $600 billion economy.

I do not want to overstate his position, but it was a most eloquent testimonial to the level of prosperity and capital outlay in existence now.

I just add that for emphasis to this paragraph.

Senator WILLIAMS. May I ask a question in connection with this, too? Do I understand that it is your feeling that in the light of the conditions that you have just described, it would be disastrous to suggest that we balance the budget at this time?

Mr. HELLMUTH. What were your last few words, Senator?

Senator WILLIAMS. Do you think it would be disastrous for us to try to live within our income in the prosperous conditions under which we are now operating?

Mr. HELLMUTH. I think we are at a record level of prosperity but we are also in my judgment not measuring up to our potential by something like $40 billion a year which I would plan to develop in my next paragraph or two.

Senator WILLIAMS. Well, all right.

Mr. HELLMUTH. Despite these record performances, however, the economy might be characterized as in a state of high level stagnation. The unemployment rate every month since 1957 has been above 5 percent, the rate of unemployment now shows no improvement over a year ago, the utilization of productive capacity is unsatisfactory, estimated earlier at 83 percent of capacity, against a favored rate of 92 percent of capacity. An increase in GNP of at least $40 billion at an annual rate is needed immediately to reduce unemployment from 5.5 to 4 percent of the labor force. In other words, a GNP of about $625 billion in 1963 would have reduced unemployment to a tolerable level of 4 percent, in comparison with an actual GNP of approximately $582 billion and an average unemployment rate of 5.7 percent.

This increase of at least $40 billion in GNP is needed now in the short run to permit a full recovery from recent recessions and achievement of a full measure of prosperity.

The rate of economic growth in the United States has been inadequate compared to our goals, compared to our historical performance, and compared to the performance of other industrial countries of the world. Our actual rate of economic growth has been about 2.7 percent a year over the last 8 years, against a goal of 4 percent.

I would add here an annual real growth of 4 percent or about $25 billion a year at the present gross national product level is needed in the long run to absorb the growing labor force and the increase in productivity.

The Federal budget by any of the three usual measures has shown a deficit in 5 out of the last 6 fiscal years, and the current year and the

1965 fiscal year are also expected to be deficit years. These chronic Federal deficits largely reflect the unsatisfactory performance of the economy compared with a full employment economy.

The present tax system would generate a surplus if in fiscal 1964 the gross national product were at least $605 billion or higher in the current year, instead of a figure about $25 billion less. Balance in the Federal budget depends on achievement of a balance in the national economy at a full employment level without inflation.

Current prospects for 1964 indicate no elements in the economy which generate a major move ahead to wipe out the shortfall of total demand. That is, not allowing for the possible tax reduction.

Consumption spending and spending by State and local governments are expected to increase at the usual normal rates of recent years. The recent McGraw-Hill survey of business investment plans projects expenditures of $40.7 billion for 1964, slightly below the present rate of $41.1 billion.

Passage of this act is the major hope of the administration and the economy to achieve full employment in the short run and a satisfactory rate of economic growth in the long run.

An active fiscal policy to promote economic expansion involves greater spending, lower taxes, or both. The Federal budget in recent years has shown significant annual increases averaging $4.1 billion a year over the last 7 years, for example. This increase in spending has had an expansionist effect, but not in sufficient strength to bring the economy to a full employment level.

Further annual increases of this approximate magnitude would continue to be helpful, but inadequate, to bring the move ahead that the economy needs. Some observers would prefer that further large increases in Government spending be the route followed to achieve full employment through an expansionist fiscal policy. A persuasive case can be made for sizable additional amounts of spending for education, health, and hospitals, recreation, natural resources, slum clearance and urban renewal, and aid to depressed areas. The choice between emphasis on greater Federal spending or lower taxes is debatable.

The administration about a year ago made the decision in favor of a major tax reduction, and against large increases in Government spending. The economics of the case for tax reduction as a means to achieve a sizable increase in gross national product is convincing. Personal incomes after taxes would rise by $8.9 billion, at an annual rate, and a large part of this, perhaps 92 to 94 percent based on recent experience, would be respent on consumer goods and services, directly providing more jobs, putting idle productive capacity to work, and creating incentives for more investment in plant and equipment.

The $2.2 billion of corporate tax reduction would encourage private investment in two ways. It would increase by about 10 to 12 percent the expected rate of return on new investments, and would also provide that amount of additional funds to finance investment and increase dividends.

An economic analysis of budget and fiscal policy of recent years indicates that the Federal budget comes into balance at a level of GNP below a level adequate to achieve an acceptable floor under economic growth and an acceptable ceiling on unemployment. The economic recovery in 1959–60 for example faded before the economy had gotten into a high plateau of prosperity.

The Federal budget on a national income account basis shifted from deficit to surplus in the first quarter of 1960 well before full recovery had been attained and while unemployment had dropped only to 5.1 percent. At the peak of the previous boom (July 1956–June 1957) the comparable unemployment rate was 4.1 percent. This suggests that Federal fiscal policy with the present tax structure tends to shift from an expansionist to a restrictive effect before the recovery has been fully achieved, and long before a restrictive, anti-inflationary policy is needed.

Thus fiscal policy, with the present Federal tax system, applies the brakes too soon and too hard. The 1963 Federal budget would have been in balance if 1962 GNP had been about $575 billion, against the actual $555 billion. A GNP of about $600 billion, however, would have been necessary to achieve a high enough level of output, income, and employment to reduce unemployment to a 4-percent rate. And I question whether the 4 percent unemployment rate is not too high to be an acceptable long-run goal, and suggest that a really acceptable ceiling would be a maximum of 3 to 3½ percent unemployment.

Not only does the present tax system provide a balanced budget when the national economy is still unbalanced on the low side; the present tax system also takes too large a fraction out of an increase in income as income rises. As GNP rises, the increase in Federal taxes is about one-third of the increase in GNP. The large and sweeping reductions in Federal rates on personal and corporate income under the Revenue Act of 1963 would reduce the marginal tax take of GNP to about 27 percent. In addition, the Federal Government budget would be balanced at a GNP about $35 to $40 billion higher than the present level at which balance would be achieved.

2. Relation of Federal spending to tax reduction: The American economy needs now an increase in GNP of at least $40 billion to reduce unemployment and measure up to a reasonable potential in the short run. This increase is needed over and above the rise in GHP resulting from gradual annual increases in private demand for consumption and investment and public demand by Federal, State and local governments.

The economic boost from this bill is more likely to be insufficient, rather than excessive, to generate an expansion of at least $40 billion in GNP. Any diminution in the magnitude of the expansionist effect through a smaller tax reduction would reduce the chances that the desired economic effects from tax reduction would be realized. The tax cut is expected to cause, directly and indirectly, an increase in GNP of approximately $25 to $30 billion.

The average increase in the Federal budget, from fiscal year 1957 through recent estimates for fiscal year 1964, has been about $4 billion annually. If Federal spending declines, or rises at a lower rate than in recent years, this will tend to offset in part the expansionist effect of the tax reduction. To achieve the same net expansionist effect from the Federal sector of the economy, a tax cut larger than the $11 billion now proposed would be needed.

The amount and composition of Federal spending should be based on the merits and benefits of the various Federal programs. These merits and benefits are not changed by tax reduction. Tax reduction, on the other hand, by strengthening the private sector of the econ-

omy—creating more income and more jobs—will tend to reduce certain Government expenditures and reduce the pressure for others.

It would be unfortunately, untimely, and perhaps wasteful to freeze the amount to be spent on existing programs or to prohibit any new programs. The economy and the world in which we live are dynamic and changing rapidly. Our population is growing and the labor force faces a record growth beginning in 1965, reflecting the bumper crop of postwar babies from 1947 on, who are currently juniors in high school.

Certainly relatively new programs meet clearly identified needs, such as job retraining, accelerated public works, area redevelopment, grants and loans to colleges and universities and their students, and aid to the retarded. These programs reflect efforts to reduce structural unemployment and chronic unemployment in certain geographic pockets, on the one hand, and to provide education and training of better quality to more people, on the other.

As requested by President Johnson, Government agencies should perform their fucntions frugally and economically. There should be continual pressure from Congress and the President for cost reduction in existing programs and a reexamination of all programs to identify and cut back or eliminate those which are no longer needed.

On the other hand, it would be unwise, wasteful, and short sighted to rule out all new programs or increases in present programs. Congress and the executive branch should continually be alert to shift funds and to increase or reduce spending to adjust to changing priorities and new situations.

If a comment is appropriate on the Federal deficit and on the Federal debt, as affected by the proposed tax reduction, I would associate myself with the statement signed by 413 economists and presented by Prof. Lester V. Chandler, of Princeton Univercity, at these hearings on October 24. In summary, this statement took the position that, under the circumstances, the increase in the deficit is not too large and that the moderate increase in the debt expected from the tax reduction is nothing to fear.

3. The opportunity and the need for tax reform: The actions of the Committee on Finance and the Senate itself provide an unmatched opportunity for a renewal of efforts for tax reform. Rate reduction is one major component of reform of individual and corporate income taxes. Structural changes to improve the equity of the tax system and to make the tax system more neutral between different types of economic activity is the other major component.

The Congress in the Life Insurance Income Tax Act of 1959 and in many provisions of the Revenue Act of 1962 has made significant progress toward greater equity and neutrality. Those two acts are examples of the steps in recent years in this direction.

H.R. 8363 presently includes a number of features which will further the cause of structural reforms, but some of the major proposals of the administration are missing entirely or have been greatly diluted. In two cases, new preferential features have been introduced without any offsetting gains to tax neutrality.

Neutrality of a tax system between different types of economic activity is a genuinely conservative goal. Members of Congress, businessmen, investors, and economists among others believe that decisions

made in free, competitive markets should generally determine price, production, investment, and employment. For more than 20 years, however, tax considerations have played a major and probably increasing role, and the forces of the free market a reduced role. Adoption of the program of tax reform together with tax reduction would be a major step toward minimizing tax factors in the decisions of consumers and businessmen. President Kennedy's tax message of January 24 pointed out that—

> * * * these preferences and special provisions also restrict our rate of growth and distort the flow of investment. * * * (these preferences) artificially distort the use of resources, inhibit the mobility and formation of capital, add complexities and inequities which undermine the morale of the taxpayer, and make tax avoidance rather than market factors a prime consideration in too many economic decisions.
>
> * * * the excessive high tax rates and the various tax concessions have in the past been associated with each other, and they should be eliminated together * * *.

Some people have given up hope for tax reform. An article entitled "The Slow, Quiet Murder of Tax Reform," by Philip M. Stern in the current (December 1963) issue of Harper's concludes that reform, although not entirely futile, is a losing battle as

> * * * over the years, the exceptions and preferences in the tax laws have grown rather than diminished in number * * *.

Like several members of this committee, although sometimes discouraged, I remain an optimist, and believe that tax reform is important and that efforts to achieve reforms have achieved some noticeable improvement.

The income tax is a precious national asset. It must not be allowed to waste away. Its strength depends in part on the confidence of the mass of the people in the justice of the tax laws and their administration. If the feeling continues to spread that the tax system favors certain groups and industries, either by preferential legislative provisions or through uneven or capricious enforcement, the people will lose confidence in the tax system, and this loss of confidence may be irreversible.

Several additional structural reforms would raise a substantial amount of revenue, and this additional revenue yield would make possible a larger rate reduction than is now included in the bill. The deterrent effect of income taxes is primarily in the higher rates.

A larger reduction in rates accompanied by the removal of more preferential features would reduce the disincentive effects of income taxes, while simultaneously making the taxes more equitable. The rate reductions proposed are so large relative to most preferential provisions removed or modified that the result for most individuals and corporations will be a net reduction in income taxes. Any additional revenue gained by removing more preferential features should be put into further rate reduction over the whole income range.

The most favorable action on tax reform which the Committee on Finance might take would be to include certain provisions recommended by the administration, but not in H.R. 8363 as passed by the House.

(1) I recommend highest priority be given to restoring a provision that unrealized capital gains be subject to taxation at times of transfer by death or gift, or, as an alternative, that basis of the decedent or

donor be carried over to the recipient. The latter version was approved in principle by the Committee on Ways and Means but agreement was not reached on statutory language to carry out this intent.

I recommend that the Committee on Finance, in view of the expectation that consideration of the bill will be carried over into 1964, include this feature in the bill. The inclusion of this provision would do more to increase the mobility of capital and improve the allocation of resources than any other single action the committee might take. The "lock-in" effect of the capital gains tax would be substantially diminished by removing the opportunity for these unrealized gains—unrealized at least at the time of death or gift—to escape income taxation, not only at the time of transfer but forever.

The Treasury's proposal provided adequately for exemptions of transfers of personal property and household goods, transfers to the surviving spouse, charitable contributions, and complete exemption below a generous minimum. The Treasury recommendation also provided for convenient installment payments and for deduction of income taxes in computing the amount subject to estate taxes.

Senator WILLIAMS. May I ask a question at that point? Do you endorse the Treasury's recommendation in that event or the President's recommendation? You see, the President did not carry any exemptions in his recommendation.

Mr. HELLMUTH. I would be happy to see the Treasury's recommendations adopted.

Senator GORE. Did you say the President did not——

Senator WILLIAMS. I don't think the President included any exemptions at all. It was a straight tax and would eliminate the exemptions. The Secretary of the Treasury, as I understand it, before the committee later did recommend that the exemption be carried as you suggested in your paper.

Mr. HELLMUTH. Your memory, Senator, I am sure is better than mine but I have a vague recollection that the President made a general proposal and suggested that the details would be presented by the Secretary of the Treasury and that there may not be a contradiction or a sharp difference between these two.

Senator WILLIAMS. Perhaps not.

Senator GORE. Mr. Chairman, since the witness has been interrupted, I would like to make just one brief interruption myself.

Doctor, in your statement you say:

> The lock-in effect of the capital gains tax would be substantially diminished by removing the opportunity for the unrealized gains to escape income taxation, not only at the time of transfer but forever.

As a matter of fact, the unrealized gains, though very real, under present law can escape taxation of any sort forever so far as Federal levies are concerned.

Mr. HELLMUTH. You say they cannot escape?

Senator GORE. They can. So in the case of restricted stock option, vast fortunes can be accumulated and passed from father to son and grandson and great-grandson, under present law, without any Federal levy being applied to these gains and fortunes at any time, anywhere, in any manner.

Mr. HELLMUTH. This is one example, sir, of the thing that I had in mind.

Senator WILLIAMS. Would the Senator yield?

Senator GORE. Would you first let him answer? Is that a correct statement of the present law?

Mr. HELLMUTH. That is my understanding of it; yes, sir.

Senator WILLIAMS. Well, now, are not they under present law subject to inheritance tax at the full market value at the date of death and therefore they would be—the unrealized gains are subject to some tax under our existing structure, are they not?

Mr. HELLMUTH. What I said is escape income taxation forever.

Senator WILLIAMS. But the question which was asked you is whether or not they escape tax forever. They are taxed at the inheritance tax rate as all unrealized gains even under existing procedure, are they not?

Mr. HELLMUTH. Yes, sir.

Senator WILLIAMS. And that runs as high at 70 percent, does it not?

Mr. HELLMUTH. Yes, it does.

Senator WILLIAMS. So in effect some of these unrealized gains are already taxed as high as 70 percent under existing law. Is that not correct?

Mr. HELLMUTH. That is correct.

Senator GORE. I would like a statement from Mr. Stam on that, whether or not the——

Senator WILLIAMS. At the time of death.

Mr. STAM. At the time of death the estate tax adopts the value at the date of death or I think 1 year from the date of death. We have an alternative in there. We do get whatever property is left at death if it is subject to the estate tax, we tax it at the value at that time. So that the appreciation up to that time would be reflected in the value at the date of death.

Senator WILLIAMS. In other words, if it is stock which was bought for $25 a share and was selling at $200 at the date of death, or that 1-year option thereafter, the tax is paid on the full $200 with no relationship to the original cost. Is that not correct?

Mr. STAM. Yes.

Senator WILLIAMS. So this tax—I am not saying that we shouldn't consider whether it is a capital gains tax or not, but to the extent that the capital gains tax was levied as recommended by the administration and by you, it would reduce the amount, the total value of the estate, and thereby there would be less tax on the estate tax, the final estate tax, or inheritance tax, is that not correct?

Mr. HELLMUTH. That would be true under the Treasury proposal, yes.

Senator WILLIAMS. What you are proposing is a double tax at the time of death, is that not so? First a capital gains tax on the unrealized income and then you are recommending the estate tax on the remainder of the estate after the capital gains tax is paid.

Mr. HELLMUTH. This would be correct. It would be, I think, parallel to the situation where some other person with the same holdings had sold those before his death and had converted to some other assets, where then the realized gain would have been subject to the capital gains tax and the estate tax would then apply to the remainder.

Senator WILLIAMS. But the point I am trying to establish here is that we are not making a decision between a tax or no tax at the time of death but we are making a decision whether it would be one tax or two taxes at the time of death.

Mr. HELLMUTH. That is correct. It would seem to me another way of stating it is whether or not the income tax would ever apply to these, given the fact that the estate tax with its different level of exemptions and different rate structure clearly does apply.

An estate tax will be levied on assets which are transferred by death, but no income tax applies on gains on capital assets in the estate. An example of two different situations might illustrate the point. In the first case, Mr. A dies, leaving a taxable estate of $100,000 for which Mr. A paid $100,000 of his after-tax income. In the second case, Mr. B dies, leaving a taxable estate of $100,000 for which Mr. B paid $5,000 of his after-tax income. Other things being equal, Mr. A and Mr. B would each pay the same estate tax. Mr. B and his heirs, under present law, would never pay any income tax on the $95,000 gain in his estate. Mr. B's tax basis of $5,000 would disappear, and his heirs would acquire a basis of $100,000.

Senator GORE. Well, if I may just complete this, I accept the correction by Senator Williams and Mr. Stam.

What is avoided or escaped under present law is the application of either an income tax or a capital gains tax at any time.

Mr. HELLMUTH. That is correct; yes. That is what I had understood you to say before, apparently incorrectly, and agreed with you. I agree with you now.

Senator GORE. Then in the case of the restricted stock option, under present law, whatever gains there may be and however easily realizable through the market, they can pass through forever without the application of either ordinary income or capital gains tax.

Mr. HELLMUTH. That is right. Yes, sir.

Senator DOUGLAS. Mr. Chairman, since we have launched upon this scene of discussion, let me say that the final proposal of the Treasury to Ways and Means on this matter was as follows, that there be a liberal exemption of $60,000 in inheritance free from capital gains taxation, that the capital gains tax only be levied when realized, not levied on the unrealized gains, and third, that the amount of the inheritance tax paid should be deducted from the amount of capital gains tax due and that only the residual then be levied as an extra tax.

I think—I have asked the Treasury to produce statistics as to what the annual yield would be with these modifications and I think it is my present intention to offer that as an amendment to the bill.

I wonder if you have any comments on that revised proposal.

Mr. HELLMUTH. I would think that would be an excellent way to get at it. It would get the major equity effect and would take proper consideration of an exemption level and of other—also not having the two taxes paid at the time if there was not realization of the gains.

Senator GORE. Well, Doctor, I notice from time to time people excuse themselves, or otherwise tend to minimize benefits, by referring to their gains as paper profits. You can sell the stuff, can't you?

Mr. HELLMUTH. Surely.

Senator GORE. So a paper profit—the phrase "paper profit" has come to be a cliche. If in our economic currency of today, a person

had realized $100,000 in paper profits in a marketable security, he has in fact very real profits which he has realized. Would you say——

Mr. HELLMUTH. I would agree with that, yes. He clearly has this much additional purchasing power compared to other people in the economy and compared to his previous situation.

Senator GORE. Or in any analysis of his worth, any financial statement, his assets would be increased by $100,000.

Mr. HELLMUTH. True.

Senator GORE. Yet this is dismissed by some as being mere paper profits. As a matter of fact, many of our profits are paper, are they not?

Mr. HELLMUTH. Yes; they are.

Senator GORE. As is the money in your billfold.

Senator DOUGLAS. Well, now, since we have launched into this discussion of economic tax etymology, may I say my good friend from Tennessee is, I think, the best authority on the dictionary that we have in the Senate. I would like to say that the definition of paper profits is only exceeded in casuistry by the term "paper loss." We had an explanation yesterday of the term "paper loss," a loss which does not occur in realty but which, because of the tax law or tax laws, can be used as an offset against profits to diminish the taxes paid to the Federal Government. When my good friend from Tennessee creates a "Gore Dictionary of Financial Terms" I suggest he define paper losses in satirical language just as he does paper profits.

Senator GORE. I shall accommodate you.

Senator WILLIAMS. Since we are in here, paper losses or paper profits cannot be counted exactly the same as the cash in your pocket. You can use your cash in your pocket at any time and paper profits can only be used when you sell, and would it not be a physical impossibility for everybody to cash in on their paper profits in the stock market? Who would buy it?

Mr. HELLMUTH. Certainly it would. There would have to be buyers.

Senator WILLIAMS. Sure, and if everybody decided to cash in their paper profits, there couldn't be enough buyers and the question that comes to my mind in considering this, paper profits do have ways of vanishing as evidenced by the precipitous break in the stock market about a year ago following the discussion on the steel prices.

Now, under our existing law and under the Treasury's recommendation, they would still take into consideration the value, the market value of an estate on the day the man dies. An estate—if a man passes away when the stock market is very high, you get this precipitous break in the meantime or after this year's lapse where he could change his valuations, the estate would then still be under the administration proposal subject to a capital gains tax on a paper profit which existed at the time of death but which had vanished completely at the time of payment, would it not? I mean that situation would readily develop under this proposal, wouldn't it, where a man would be paying a sizable capital gains tax on a large potential paper profit which did exist at the time of death or 1 year thereafter but which had completely vanished into thin air as a result of the break in the stock market.

Mr. HELLMUTH. Might I appeal to Senator Douglas for assistance on the instance he cited?

Senator WILLIAMS. Senator Douglas' instance would correct that, his recommendation as he made to the Treasury Department would correct that somewhat. But the——

Senator DOUGLAS. Correct it completely.

Senator WILLIAMS. That is right. But the proposal which you are recommending here, that capital gain at the time of death—that would not correct it.

Mr. HELLMUTH. I am afraid I should have done my homework more carefully. I didn't go through every one of the seven volumes of the Committee on Ways and Means and am not well acquainted with the last version of the Treasury's proposal. I think that would be an improvement and I would certainly accept that as——

Senator DOUGLAS. I am not certain that it even appears in the printed record. I have not gone through all the seven volumes.

Senator WILLIAMS. I think it is in the committee.

Senator DOUGLAS. But there was an offer made which may have been made in executive session, but I have checked with the Treasury and they confirm the fact that this modification was offered.

Senator WILLIAMS. You are correct. The modification was offered. If I am not mistaken, they did include it in our record here before the committee as a supplement, I think.

Senator DOUGLAS. In response to a question which I asked.

Senator WILLIAMS. Yes, I think so.

Senator GORE. Off the record.

(Discussion off the record.)

Mr. HELLMUTH. Senator Williams, my main point was not to advocate vigorously a single version of the proposal but to suggest that it seemed to me most inequitable that there be a situation in which gains could be carried through perhaps from generation to generation and never become subject to either the ordinary income tax or the capital gains tax, and I had suggested that possibly the Ways and Means version, which was that the basis of the donor or the decedent be carried forward, would be another way that would keep subject to tax the gain with the tax to become a liability at the time the gain is realized.

Senator GORE. Mr. Chairman, I suggest that my distinguished colleagues from Illinois and Delaware take a look at an amendment which I have already introduced in this regard, which may be very close to their point of view, and it just may be that the Treasury ought to be asked to comment upon it.

Senator DOUGLAS. It is identical with the suggestion which I have made. It is an indication of the way in which great and noble minds tend to complete agreement. I doubt that the Senator from Delaware will accept it now.

Senator WILLIAMS. I want to look at it before I accept it, but what I was trying to get clear in the record was that they are not escaping taxes altogether as was indicated in your first understanding. They are presently being taxed at the full market value at date of death or as an election, they can select the market value 1 year from that date under existing law. But in any event, the full market value on all unrealized income, stock options or otherwise, are taxed under existing law to some extent now.

Mr. HELLMUTH. Are taxed under the estate tax. I indicated "to escape income taxation" and I am afraid did not answer one of the questions correctly.

To resume, the Treasury recommendation would greatly improve the equity of the tax system, by making subject to tax unrealized gains of large magnitude which now avoid completely any Federal income tax. Mr. Harvey Brazer, then head of the Treasury's Office of Tax Analysis, estimated the unrealized capital gains now exempt from income tax by transfer through gift or death at about $12 to $13 billion annually.

Under the Treasury's proposals, as I understand them, not all that $12 or $13 billion would get into the base. Some of this would certainly be taken out by the exemptions that are suggested.

Secretary Dillion, earlier in these hearings (at p. 308), said of this feature:

> I think if we had had that capital gains tax at death or carryover basis it would have been one of the great advances that has been made.

The inclusion of only 40 percent of gains on capital assets held more than 2 years, now included in the bill, should be stricken, as recommended by Secretary Dillon, in the absence of other and new provisions to tighten the tax treatment on these gains. However, if income taxation of unrealized gains at death, or carryover of basis is added to the bill, I would recommend that the 40 percent rate on capital gains narrowly defined held for more than 2 years be continued.

I think this latter position, keeping the lower inclusion and making the other change, would be much preferred in terms of both equity and economic effects.

(2) Second priority would go to further tightening of the tax treatment of natural resources. The administration recommended four changes with a net revenue gain of $185 million a year (a revised estimate included in Secretary Dillion's testimony), but the House adopted only one of these reforms with a revenue gain of $40 million.

Inclusion of the other three recommendations of the administration, covering carryover of excess deductions in computing net income, capital gains from the sale of mineral properties, and separation of deductions on foreign operations, would be a modest step in reducing preferential treatment of the gas, oil, and other natural resources industries, compared to other taxpayers. The net gain of $185 million—that is an additional $145 million—would be a very small percentage of the total of approximately $5.6 billion now available through percentage depletion and the intangible drilling and developments costs. Of course, a renewal of the bipartisan effort of courageous Senators to reduce the percentage depletion allowances would be a more straightforward and effective method to achieve the result of tax neutrality and equity.

Senator DOUGLAS. I ask that the Senator from Delaware be permitted, Mr. Chairman, to take a bow. There are others here who would take a bow, too, if requested.

Mr. HELLMUTH. My only observation here might be that most of the people entitled to take a bow are now in this room. It is too bad that the number isn't much larger.

Senator WILLIAMS. It may be larger than you think when we get through voting.

Mr. HELLMUTH. We hope so. Some of us will hope so.

My third priority recommendation is that the definition of the income subject to capital gains treatment be tightened to exclude gains from stock options, the sale of timber, and livestock, and lump-sum distributions. Also, the addition of capital gains treatment to iron ore royalties, made for the first time in H.R. 8363, should be stricken. With significantly lower rates on ordinary income, the possible earlier justification for capital gains treatment for these kinds of income is removed.

I should also add that the averaging provision makes the desirability of capital gains treatment much less necessary.

The administration, the Ways and Means Committee, and the House of Representatives are to be commended for numerous actions including those on minimum standard deductions, income averaging, the limitation on deductions for certain State and local taxes, the allowance of deductions for casualty losses only above $100, the restriction on the exclusion of sick pay, and the exclusion of deductions for premiums on certain group term insurance. They are also to be commended for the removal of the dividend credit and for the tightening of the treatment on personal holding companies. The Ways and Means Committee is also to be commended for its initiative on bank-loan insurance, whereby deduction for interest charges is denied when it is associated with a systematic plan to borrow to pay premiums on life insurance policies.

The tightening of tax treatment on stock options is also to be commended, as a significant step in the right direction; this not only limits a tax inequity but eliminates tax features which made the tax treatment of stock options inconsistent with the basic rationale of these options, namely, to identify the interests of management with those of stockholders.

Senator GORE. Mr. Chairman, I hope you begin to see why I thought it was important for this witness to give his statement.

The CHAIRMAN. Yes, sir. I agree with you.

Mr. HELLMUTH. Stronger incentives and more purchasing power to promote both private consumption and private investment are needed to achieve a large and sustainable economic expansion. Tax reduction to promote only investment is not enough. This approach seems to have dominated tax changes at the Federal level for the last decade.

The Revenue Act of 1954, for example, emphasized strengthening the incentives and the financial capacity to invest by such provisions as more liberal deductions for depreciation and the dividend-received credit. The Revenue Act of 1962 emphasized the investment credit to stimulate new plant and equipment expenditures. Administrative action in 1962 on depreciation guidelines followed the same path. All of these actions concentrated on encouraging investment as the means to reduce unemployment and increase the rate of economic growth.

The only general tax rates to be changed over this period have been increased rates on gasoline and on social security taxes, both regressive taxes, only partially offset by reductions in certain excises on travel. In other words, major statutory changes have resulted in higher rates on certain regressive taxes—and lower effective rates on corporate and other business income.

It is not possible to be certain what the effects of the actual tax changes have been, or what would have been the situation in their absence. It is clear, however, that the recent emphasis on tax incentives for investment has not been successful in reducing unemployment even to 5 percent—much less to 4 percent—or in raising the growth rate to 4 percent. It is also clear that corporate business in general does not now lack funds to finance its investments.

Senator GORE. Mr. Chairman, I cannot resist asking a question there.

The CHAIRMAN. Go ahead, Mr. Senator.

Senator GORE. Upon what basis, then, can anyone confidently conclude and predict that a further increase in tax incentive for investment will accomplish that which it has failed to accomplish, to which you have just testified?

Mr. HELLMUTH. I think the hope would be that the increased rates of return that would come along as a result of the lower rates would be a spur to further investment.

Taken alone, it would be a spur to further investment mainly in cost-reducing types of investment because in many industries we have idle capacity that has to be put to work first before we are likely to get much net expansion or investment that will lead to expansion in output.

Senator GORE. Well, your answer is, then, that there are hopes. These same hopes were advanced before this committee heretofore in support of tax incentives for investment. As you have said, the hopes were not realized and you also just said:

> It is also clear that corporate business in general does not lack funds to finance its investments.

As a matter of fact, as I cited earlier, Dr. Heller stated on television this morning that the planned capital outlays were at an all-time high and you cannot cite only the liquidity of corporations, cash reserves, retained earnings, level of profits, but also a very high level of personal savings. There are also ample funds in insurance companies, banks, savings and loan institutions. So if there is no need, as you say, for more investment capital and if the incentives for investment heretofore have failed to bring about a realization of these hopes, how can we with any confidence proceed upon the notion that, despite the failures of the past, we must proceed nevertheless with hope that these measures will accomplish that which they have failed to accomplish?

Mr. HELLMUTH. I think the difference here might be that the bill does more than expand incentives which had been the major emphasis of other recent bills. It also provides a substantial spur to increase consumption, to make the additional increase of investment worth while, to make investment for expansion worth while.

The concern I have is whether the balance between these two is proper, whether perhaps there might not be a stronger inducement to, and more provision of the purchasing power to provide this consumption that will take off the market the things that the businessmen have to sell and which they would have to sell in more abundance and perhaps at lower cost if they undertake more investment.

Senator GORE. Well, if I may interpret your statement and your two replies to my question, it seems to me that incentives for investment have not accomplished the desired hope heretofore, that there is no

particular shortage of investment capital now, and therefore no particular need for further tax incentives, the emphasis having been for the past 10 years upon the creation of just such tax incentives, and therefore the real need for stimulus in the economy is in consumer demand.

Would that be a fair interpretion of your answers and statements?

Mr. HELLMUTH. This would certainly be the emphasis of my statement. If I were writing an economic analysis and did not have political problems to be concerned with, I would certainly put very heavy emphasis on support for consumption, given the other types of changes that have occurred in recent years to make investment more attractive.

Senator GORE. Mr. Chairman, since I have interrupted, and I apologize to the committee for doing so, I would like at this point, if I may, to read from a transcript of Dr. Heller's statement this morning.

The CHAIRMAN. Without objection.

Senator GORE. This was given to me by a stenographic service that transcribed the program called Today, a program on which Dr. Heller was interviewed by the distinguished commentator and reporter, Martin Agronsky.

"Well, in looking ahead"—before quoting, as I recall it, Mr. Agronsky had asked Dr. Heller about his conference with President Johnson yesterday as to the state of the ec^nomy. And here was his reply:

> Well, in looking ahead, we examined some of the prospects of the economy; we looked at the very good prospects as far as automobiles, housing; as far as capital spending by business. Plant and equipment appropriations are at a new high. I think what we were looking at were essentially the sources of strength in the economy and we found them reassuring. We found a solid basis for what had happened in the stock market the other day—a solid basis for the confidence that has been expressed in the economy. Indeed, I think we can look forward very confidently within the next month or two to topping that magic $600 billion mark in the Nation's rate of output.
>
> Mr. AGRONSKY. How far are we from it now?
>
> Mr. HELLER. Well, we must be—we don't measure it from week to week * * * within striking distance right now * * *.

He proceeded to say that the real purpose of the proposed tax cut was to give insurance against a recession in 1964. Well, 1964 is an important year, but so is 1965 and 1974.

Now, Doctor, with respect to this solid basis for the stock market rise the other day, I note you refer in your statement to the prospect of increased dividends. Do you realize that corporations are now distributing an average of about 66⅔ percent of profits in dividends whereas the traditional, shall I say, rule of thumb, for want of a better phrase, has been the distribution of about 50 percent in dividends and the financing of capital outlays and expansion with the other 50 percent, plus capital consumption allowances and now, outside money.

Now, this greater percentage distribution of dividends has been brought about largely by the tax concessions which the Congress has enacted and which the administration, by regulation, made possible through changes in depreciation. This is an artificially high level and an artificially induced high level of dividend distribution or distribution of profits through dividends. This is an artificial stimulation of the economy, of the stock market, and it is proposed further to artificially stimulate it for 1964.

But what happens in 1965 and 1966 and 1967? Do we artificially stimulate again in 1966 and again in 1968? Where does this lead us?

Will you comment?

Mr. HELLMUTH. Well, I would hope that we would have a base that is firmly rooted and not one that depends on artificial stimulation every 2 years or——

Senator GORE. That is a fine hope. We had this hope or at least this hope was expressed, in the 1954 action. This hope has been advanced in support of the tax incentives to which you have already alluded, but the fact is that after the expansion in capital plant in 1956 and 1957, the consumer demand did not follow through and again we found unused productive capacity. We found idle plant. We found a high rate of unemployment. Yet it is the same temporary, artificial panacea that is advocated by the pending bill.

You say you hope this bill is enacted. But I find no basis for a reasonable hope that it would succeed in these regards.

Mr. HELLMUTH. Well, I have tried to do two things here, I think, that are pertinent to your question and your comments.

One, to suggest that the bill in general is good and that it should be enacted, and secondly, that there should be some changes made in it while it is still in the legislative process to make it a better bill.

I am hoping that the changes that I am suggesting would move, I believe, in the direction of making this less possibly an artificial stimulus and more a solidly based stimulus to redistribute in part the tax reductions so that somewhat more of it goes into the consumption area and that also some of the preferential features that would still be in the bill as it has reached this committee would be removed and that there might be further rate redutcions on a broadly based range to increase the purchasing power of consumers and also sharpen the incentives I think for businessmen and investors.

Senator GORE. Well, I would like to conclude and say that it seems to me that you and Dr. Heller together have today lessened the case for massive tax reduction.

Thank you, Mr. Chairman. I apologize for the further interruption.

Mr. HELLMUTH. It is also clear that corporate business in general does not lack funds to finance its investments.

Funds generated internally in 1962 and 1963 equaled or exceeded the amounts spent by corporations for new plant and equipment. There is also much unused plant capacity in the economy. Increased incentives to invest are hollow if there is not a large and rising level of consumer demand to buy the expanding output made possible by the increased investment in plant and equipment.

Combining the 1962 changes and the proposed Revenue Act of 1963, corporations will receive about $4.5 billion of tax reductions. To the extent this tax reduction benefits stockholders, the greatest benefits will go to the 8.7 percent of taxpayers with incomes above $10,000, who in 1960 based on statistics of income received 72.7 percent of all dividends reported on tax returns.

The reduction in tax on individuals will increase after tax income by $8.9 billion of which $3.6 billion goes to taxpayers with incomes above $10,000 a year and $5.3 billion to taxpayers with income below $10,000. Most of this will be spent to increase consumption, probably

at least $8 billion. This large, direct increase in consumption spending is the most certain and most stable result expected from the tax reduction.

The larger the reduction going to individuals, and the larger the percentage going to lower income individuals, the larger the increase in consumption spending from a tax cut of a given size. More consumption would mean more jobs for the unemployed and work for the idle machines. Fuller utilization of plant and equipment would provide incentives for more investment to add to productive capacity. Funds are generally available now; incentives for expansion are lacking in part due to idle capacity.

H.R. 8363 together with the Revenue Act of 1962 makes a "balanced" reduction in income taxes, with the relative amounts on personal and corporate income taxes approximately in proportion to the yields of these two taxes in fiscal 1962.

I have used fiscal 1962 because this would be before the effects of either of these two changes became apparent. And I have here a table that shows about two-thirds of the income taxes come from the individual taxes and about two-thirds of the reductions would go to individuals under the income tax. The remaining one-third roughly going to corporations.

(The table referred to in the preceding paragraph follows:)

Income tax	Revenue, fiscal year 1962		Reductions, full year effect	
	Billions	*Percent*	*Billions*	*Percent*
Individual	$45.6	68.9	$8.8	66.2
Corporate	20.6	31.1	4.5	13.8
Total	66.1	100.0	13.3	100.0

Another approach is to consider the relative role of income taxes in Federal receipts, before and after the changes proposed in H.R. 8363. The following table presents a rough comparison of the present tax law and the effects of H.R. 8363 as passed by the House of Representatives and the Revenue Act of 1962, based on fiscal year 1962.

(The table referred to follows:)

Federal receipts from the public	Fiscal year 1962, actual		Fiscal year 1962, assuming Revenue Act of 1962 and H.R. 8363 fully effective	
	Billions	*Percent*	*Billions*	*Percent*
Individual income tax	$45.6	44.7	$37.0	41.5
Corporate income tax	20.5	20.1	16.4	18.4
Subtotal	66.1	64.8	53.4	59.9
All other receipts	35.8	35.2	35.8	40.1
Total	101.9	100.0	89.2	100.0

Mr. HELLMUTH. The effect of the actual changes in 1962 and the changes proposed in H.R. 8363 would be to reduce the relative importance of both the personal and corporate income taxes in the Federal tax system, and to increase the relative importance of excise taxes, employment taxes, and other revenue sources. Income taxes on individuals would be reduced from 44.7 to 41.5 percent as a source of

Federal receipts, and income taxes on corporations from 20.1 to 18.4 percent. Other sources would increase from 35.2 to 40.1 percent in importance. The percentages for future years would vary from these, in part due to the built-in rate increases in employment taxes, the largest single source in "other receipts."

The significance of this reduction in the relative importance of Federal income taxes is a shift away from progressive taxes toward regressive taxes. As these income taxes are the major progressive element in the Federal, State, and local tax systems, a reduction in the importance of Federal income taxes tends to make our total tax system less progressive and therefore less equitable on the basis of ability to pay.

To the extent that equity is an important objective of the tax system, we must strive to see the equity goal is not submerged in the attempt to sharpen economic incentives. We must maintain a reasonable balance between the important and sometimes conflicting objectives of equity and incentives.

The CHAIRMAN. Thank you very much.

Senator Douglas?

Senator DOUGLAS. I want to congratulate Dr. Hellmuth on a splendid discussion which I think has been one of the most illuminating that we have had.

I would like to ask him whether the purport of his last paragraphs there should be some reduction in excise taxes as well as in income and corporate taxes.

Mr. HELLMUTH. This would seem to me part of a really balanced program to look at the whole range of Federal taxes, not merely of the income taxes alone although I realize the income taxes alone are an enormous job.

The effects of including excise taxes in the consideration would, I believe, be to provide more incentives to consumption and at least to certain types of investment that are now disadvantaged.

Senator DOUGLAS. Do you have particular excise taxes that you would like to see reduced? I take it you would not want to see excise taxes on tobacco and liquor reduced. As I remember Oberlin was quite the center of antisaloon activities, I think the Anti-Saloon League started in Oberlin so I think, you would not want to have taxes on liquor reduced, would you, or on tobacco, but what other?

Mr. HELLMUTH. Oberlin still happens to be dry by local option although this doesn't necessarily reflect all of the personal habits of people in town.

Senator DOUGLAS. You are concerned for the welfare of your fellow man and not for the preservation of your own virtue.

Mr. HELLMUTH. I think we would be more interested here in moderating the regressive nature of that part of the tax system.

Senator DOUGLAS. Specifically what do you think of the telephone tax?

Mr. HELLMUTH. I would think it would be desirable to reduce this, particularly the rate on local calls.

Senator DOUGLAS. Very well.

The second question I would like to ask, What would you think about a lesser decrease in the corporate tax and a greater decrease in the income tax under $10,000 income? That is, instead of reducing the

corporate tax from 52 to 48, reduce it from 52 to 50 and some $600 million thus saved be applied to a lowering of the income scale.

Mr. HELLMUTH. I would think economically that this would be desirable. I think there is a psychological gain by getting the tax rate below 50 percent and perhaps stopping at 49 percent and using a somewhat lesser amount than you suggested might achieve this double goal of the real problem and the psychological problem.

Senator DOUGLAS. Now, the final question that I raise is this: You, I think, have correctly spoken of the fact that if you tried to stimulate the economy through a tax cut, if expenses are reduced commensurately, you cancel the stimulative effect, and I agree with you on this point.

Suppose the Federal Reserve Board decides that the tax cut is to be accompanied by an increase in interest rates and a curtailment of the amount of demand deposits or failure to expand demand deposits commensurately with the potential increase in production. Doesn't this cancel——

Mr. HELLMUTH. This would certainly have a restrictive effect offsetting the tax cut, at least in part. It would be normal for the Federal Reserve not to do this as a result of the passage of the bill but to wait to see that there were economic indicators suggesting inflation or other situations that would call for tight money.

Senator DOUGLAS. You know that the European bankers are urging upon us a policy of higher interest rates and which could either be effected directly or could be effected through curtailing the amount of bank credit through the sale of securities in the open market, and that there is supposedly a very strong group inside the Federal Reserve Board which favors just this policy, a restrictive monetary policy, at the same time that we have an expansive tax policy and budgetary policy. Does that make sense?

Mr. HELLMUTH. This would seem to me to offset directly the incentives that we are attempting to gain, one, by bolstering consumption and, two, by reducing corporate tax rates.

Senator DOUGLAS. I heartily agree, I heartily agree with you. I only hope that the representatives from the Federal Reserve Board here take cognizance of your testimony.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. I yield to Senator Dirksen.

Senator DIRKSEN. I have no questions.

Senator WILLIAMS. Doctor, I have one further question which I didn't see touched on in your report. Would you favor the eliminating of the unlimited charitable contributions deductions as recommended by the Treasury Department?

Mr. HELLMUTH. Yes, sir, Senator Williams, I would.

Senator WILLIAMS. Do you believe that most of the colleges generally agree with that position?

Mr. HELLMUTH. I shiver a little bit here because I am not sure. I am certain I am in no position to speak for the colleges. I think the other changes in the law, either that are now in the law or which I have tried to suggest this morning, would leave the colleges and universities and other charitable institutions in at least as strong a position as they now are.

Senator WILLIAMS. Would you make any recommendation for any change in the present formula for treating the tax in connection with tax foundations or foundations, I mean, nontaxable foundations?

Mr. HELLMUTH. I am afraid I am not prepared on that point.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Senator Gore?

Senator GORE. Doctor, I wish to congratulate you upon your statement. I hope that you realize the deep concern that this committee has over the subject on which you have testified.

You have just responded to Senator Douglas that a restrictive monetary policy would tend to cancel out the stimulative effect of tax reduction. The extent that it tended to cancel out would, of course, have to be measured by the amount of stimulation generated by the tax cut and the amount of restriction generated by a restrictive monetary policy. On a $600 billion economy that moves principally on credit, how great an effect would be produced if we had, let us say, an increase of one-fourth of 1 percent or one-half of 1 percent in the general interest rate structure?

Do you have any way of measuring how much stimulation from tax reduction would be necessary to offset a general increase of one-half of 1 percent in the interest rate level?

Mr. HELLMUTH. I am afraid I have made no studies that could give any quantitative estimates to your question.

Senator GORE. Isn't it possible that a much greater stimulus than that proposed in the bill might be necessary to offset a general increase of one-half of 1 percent in the interest rate level?

Mr. HELLMUTH. It certainly would be necessary that there be a greater expansionist effect than the bill now proposes, given present circumstances if the Federal Reserve did undertake a restrictive policy. This would clearly work in the field of mortgage credit and homebuilding. It would work in the market for automobiles and other durable goods which are two of the areas that are our strongest support in our present almost $600 billion economy that you cited.

Senator GORE. Well, to view this problem from a little different level, suppose that the Federal Reserve Board, as Chairman Martin has already indicated, insists that the increased deficit be financed out of savings.

To what extent would the financing of the increased deficit resulting from a decrease in governmental revenue be offset in stimulative effect by the financing of the deficit out of savings?

Mr. HELLMUTH. This is a good question. I must use it on my class sometime. [Laughter.]

The stimulating effects of the tax cut clearly are going to be dependent in part on how the deficit is financed and in part on what the other demands are for savings in the economy.

If corporate borrowing and new equity issues, the demand for mortgages, the demand for consumer credit are not large enough to use all of the savings that are freely generated, then the Government, by putting, by borrowing this money and putting it to use would be not holding back on the expansion. If there are private demands for the savings, then the Government would be competing for them, and probably would have to force up interest rates in order to get its share of the savings.

Senator GORE. But you have this circle like a dog chasing its tail. The Government borrows the money to give tax reduction in order that those who get tax reduction will have more savings in order to buy more Government bonds, and thus you go, and where is the stimulative effect?

Mr. HELLMUTH. Well, only a fraction of the tax reduction will go into savings, and to the extent that at least by recent record is going to be somewhere in the order of 6 to 8 percent overall, at least with personal income, the other 92 to 94 percent will go directly into the market for consumer goods and services and will have an expansionist effect.

Senator GORE. Well, let us suppose the entire increase in the deficit, as a result of revenue lost by this bill, will be $1.4 billion this fiscal year, and this part of the deficit is financed out of savings.

Would not that tend to cancel the stimulative effect?

Mr. HELLMUTH. It would—I don't think it would entirely cancel this out. There would be an expansionist effect here. It would be a more moderate expansion, and if this were financed by borrowing from newly created bank credit or borrowing directly from the Federal Reserve we would have to try to analyze how that $1 billion-plus would otherwise have been used. If it had been relatively idle, then putting it to work would not reduce the expansionist effect. But if the Government has to compete for it with individuals who wanted to buy homes or business firms who wanted to buy new machines then it would reduce the expansionist effect.

Senator GORE. So you are saying, as I understand it, that if the deficit is financed out of an excess of savings, which is already idle, then its offsetting effect would be reduced. But, on the other hand, if the deficit is financed out of savings which might otherwise go into investment, then it would be canceled out.

Mr. HELLMUTH. Yes, this is right.

Senator GORE. Well, I think that I agree with that answer.

Now, a great deal has been said, Doctor, about an $11 billion tax cut. You just heard the staff give an estimation—Mr. Woodworth, would you give for the record the amount of reduction in revenue for the current fiscal year from the proposed bill, and for the 1965 fiscal year?

Mr. WOODWORTH. For the current fiscal year, after taking into account the Treasury estimate of the feedback, it is——

Senator DOUGLAS. Excluding feedback.

Senator GORE. Will you speak a little louder?

Mr. WOODWORTH. Yes.

Senator DOUGLAS. Excluding the feedback.

Senator GORE. Excluding the feedback.

Mr. WOODWORTH. All right, excluding the feedback it is $2.2 billion for the current fiscal year, and $7.4 billion for fiscal year 1965.

Now, the figures I gave you before were taking into account the feedback effect.

Senator GORE. Would you now give us that?

Mr. WOODWORTH. Taking into account the feedback for the fiscal year 1964 the estimate is $1.8 billion, and for the fiscal year 1965 it is $3.5 billion.

Senator WILLIAMS. Do you have 1966 there?

Mr. WOODWORTH. No.

Senator GORE. Thank you very much.

Well, Doctor, I have now asked you about the possible cancellation of the stimulative effect of the tax reduction by (1) an increase in the interest rate level and (2) the financing of the deficit out of savings.

You have said in your statement that a corresponding reduction in governmental expenditures would cancel out the stimulative effect of the tax reduction and appropriation bills are reduced by $9 to $10 billion for the current fiscal year, what would be the effect?

Mr. HELLMUTH. $9 to $10 billion?

Senator GORE. Yes, there has already been a reduction of $5 or $6 billion from budget estimates. Measure that, will you, against the estimated reduction in revenue of $1.8 billion, after allowance for feedback, but premised on the enactment of the current budget as presented by the late President.

Mr. HELLMUTH. One minor point: The reduction in appropriations will not be immediately felt in spending of the current fiscal year.

Senator GORE. I agree.

Mr. HELLMUTH. But leaving that aside because that is not part of your question, if we do get reductions in spending of $6 to $9 billion against the tax cut that is proposed, we are going to wipe out most of it, most of the expansionist effect in the long run and will more than wipe it out in the short run, because the tax cut bill that is proposed is in two stages with the full effects. Even if we looked ahead, say, 2 or 3 years, when the full effects were at work, the $11 billion reduction would be just about canceled out, in full by the higher range of the figures you have cited, I think it was $9 billion. That $11 billion of tax cut and $9 billion of expenditure might well leave us in roughly the same situation.

Senator GORE. Then when you add the third factor, on which you have already expressed views, of a restrictive monetary policy, would we, in your opinion, wind up next year with an expansionary economic policy or a more restrictive economic policy?

Mr. HELLMUTH. If all three of these things were to happen together, I would certainly think that the Federal policy would be restrictive.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Doctor, thank you very much, sir.

You made a very interesting and thought-provoking statement, and we appreciate what you have said.

Mr. HELLMUTH. Thank you, sir.

The CHAIRMAN. Now, Mr. Sterling Bigler is unable to be here. The Chair recognizes Mr. Harry J. Gerrity for 2 minutes to make an insertion in the record.

STATEMENT OF STERLING BIGLER, PAST PRESIDENT, NATIONAL ASSOCIATION OF BUILDING OWNERS AND MANAGERS; PRESENTED BY HARRY J. GERRITY, GENERAL COUNSEL

Mr. GERRITY. Mr. Chairman, Mr. Bigler regrets very much that he could not appear this morning and he asked me to appear in his stead.

My name is Harry J. Gerrity and I am general counsel of the National Association of Building Owners and Managers. Mr. Bigler

was scheduled to appear on November 25, but he has other engagements and would not be able to appear before the committee.

In order to save the time of the committee, I would like to submit Mr. Bigler's statement and hope that the Senators will have a chance to read it over and also the staff of the committee and also the staff of the Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. It will be inserted in the record.

Mr. GERRITY. Thank you very much.

(The prepared statement of Mr. Bigler follows:)

STATEMENT OF STERLING BIGLER, CHAIRMAN, LEGISLATIVE POLICY COMMITTEE ON BEHALF OF THE NATIONAL ASSOCIATION OF BUILDING OWNERS AND MANAGERS

My name is Sterling Bigler; and I live in Philadelphia, where I manage properties for the Girard Trust Corn Exchange Bank. I am a past president of the National Association of Building Owners and Managers, and served two terms, 1955–56. I am accompanied on my right by our association's general counsel, Harry J. Gerrity, who has also been our Washington representative for many years.

Mr. Chairman, the National Association of Building Owners and Managers is composed of 62 local associations throughout the United States, and represents to a great extent ownership of office buildings, and other owners of commercial real estate located principally in the downtown areas of our larger cities.

At our 56th annual convention at Miami Beach, Fla., early in July of this year a resolution was unanimously adopted, which would urge that Congress remove the discrimination which presently exists against depreciable real property, and which we feel to be unfair. More particularly, we refer to the 7-percent investment tax credit as contained in section 2 of the Revenue Act of 1962 (76 Stat. 962), and also under the new guidelines for depreciation issued by the Treasury Department in July of last year.

During the last 15 years commercial real estate has been confronted with a very substantial increase in local taxes. School taxes have increased very rapidly and commercial buildings bear more than their share of the local school taxes which in large cities is, indeed, a very substantial sum. It is recognized that our schools are in desperate need of additional funds and the office building industry is heavily taxed for these funds. Our industry helps to relieve some of the pressure for Federal funds for our school system. Real estate taxes for other local functions are also putting an increasingly heavy tax burden on our membership.

The bill (H.R. 8363) as passed by the House contains an amendment in section 202 (p. 35) relating to the treatment of both new and used escalators and elevators for purposes of the 7-percent investment tax credit, of which we heartily approve, and which we believe is a step in the right direction. However, we are recommending, for reasons which I shall later explain, that this amendment be broadened and enlarged to include all capital expenditures which a taxpayer may make during 1964, and subsequent years, for purposes of modernizing, rehabilitating, remodeling, or substantially improving any commercially used building or its structural components, including expenditures for either repacements, alterations, or additions thereto.

It is our opinion that the Treasury Department is taking a very unfair position against owners of commercial real estate, with the result that taxpayers who own such properties have been denied any additional depreciation under the new guidelines and rules, issued in July of last year, as well as the benefits of the 7-percent investment tax credit under existing law. In support of the President's 1963 tax recommendations (H. Doc. 43, 88th Cong., 1st sess., Jan. 24, 1963), Treasury Secretary Dillon submitted to the Ways and Means Committee a lengthy statement, which contained the following pertinent paragraph:

"The removal of real estate tax shelter abuses is an important aspect of the recommended reductions in the capital gains tax for individuals and corporations. Without the proposed corrections, the substantial liberalizations recommended in the capital gains tax to reestablish greater capital mobility and freer flow of investment funds generally would not be justified in the real estate field. Adoption of the proposals will also make it possible to review guideline lives for buildings and facilitate more flexible administrative treatment in this area.

Because of existing abuses, it was impracticable to change the old bulletin F lives for buildings in connection with the recent depreciation revision put into effect with Revenue Procedure 62–21, effective July 12, 1962."

We believe that the so-called real estate tax shelter abuses have been greatly overemphasized, and we believe that the vast majority of owners of real properties in the downtown areas of our large cities should not be penalized for the so-called abuse of a small percentage of speculative owners of real property. We also earnestly believe that with the passage of time the economic laws of the marketplace have provided a sufficient answer to the question of whether or not a loophole existed, or still exists, in regard to the use of accelerated depreciation in the computation of capital gain in the case of the sale of office buildings, apartment houses, and other real estate.

The present House bill (H.R. 8363) adds a separate provision designated section 1250 covering "Gain from the Dispositions of Certain Depreciable Realty." This section 1250 eliminates the so-called tax shelter of the short term owner of real estate. It was stated in a letter dated October 14, 1963, to Chairman Byrd by the chief of staff, Joint Committee on Internal Revenue Taxation (appearing in the Congressional Record of October 15, p. 18539) that less than $2.5 million would be the revenue gained from this provision for the full fiscal year 1965, and when fully effective the anticipated revenue gain in subsequent years would be only approximately $15 million. So the abuse cannot be great enough to penalize all owners of real estate. We believe that section 1250 is unnecessary, but that is not the main purpose of appearing before you.

The wave of new construction in the core area of our large cities has made thousands of old buildings obsolete. Many of them are beyond hope of any rehabilitation that would be economically sound. They are gradually being demolished. However, the great majority could be rehabilitated, by installing new elevators, air conditioning, new lighting, new ceilings, new transformers, and new wiring to handle the modern electric load requirements, new lobbies, etc. to make them economically competitive with the new look in office buildings. In most cases this would cost considerably more than the original cost of the building. It would seem that this type of plant improvement to stimulate capital investment was what the President referred to in his message of April 20, 1961, as an incentive for modernization and expansion of machinery and equipment. When the 7-percent investment credit was enacted in the Revenue Act of 1962 (Public Law 87–834, approved Oct. 10, 1962), buildings and their structural components were excluded. This exclusion covered the following types of buildings:

Apartments
Banks
Dwellings
Factories
Garages
Grain elevators
Hotels
Loft buildings
Machine shops
Office buildings
Stores
Theaters
Warehouses

The Treasury Department in its proposed regulations defines "buildings" and "structural components." The latter is defined as follows:

"(2) The term 'structural components' includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors ,all components of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building."

The 7-percent investment credit, were it allowed for the rehabilitation of old structures, in many cases would be the deciding factor as to the economic advisability of modernizing the building, and it is this type of investment that can greatly stimulate business and at the same time improve the condition and appearance of core areas, which is also a concern of Congress under urban renewal.

The House report on the pending bill states (p. 35) that the proposed regulations of the Treasury Department, covering the 7-percent credit for investment in certain depreciable property (as printed in the Federal Register of Mar. 28, 1963, pp. 3028–3050) provide an extensive list of the type of items considered to be "structural components", and therefore not eligible for the investment

credit. Among these items were escalators and elevators, but the report also significantly added the following:

"While these regulations are an accurate interpretation of the intention of Congress last year in this respect, nevertheless your committee believes that it is appropriate to reconsider the treatment of escalators and elevators for purposes of the investment credit. Escalators and elevators are closely akin to assets 'accessory to the operation' of a business which presently are eligible for the investment credit. These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. Your committee further believes that new elevator and escalator equipment represent an important aspect of medernization of plan and facilities."

The House Report No. 749 (pp. A27 and A28) on the pending bill defines an "elevator" as follows:

"* * * a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and functionally related equipment which is essential to its operation. Such term includes, for example, guide rails and cables, motors and controllers, control panels and landing buttons, and elevator gates and doors, which are essential to the operation of the elevator. The term 'elevator' does not, however, include a structure which is considered a building for purposes of the investment credit. For purposes of section 48, the term 'escalator' means a moving staircase and funtionally related equipment which is essential to its operation.

"For purposes of determining qualified investment under section 46(c) of the code, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of constructing a shaft or of making alterations to the floor, walls, or ceiling, even though such alterations may be necessary in order to install or modernize the elevator or escalator * * *."

We feel that the structural changes necessary for the installation of new modern elevators in an existing building should be included in the 7-percent investment credit, as it is a part of the incentive to modernize.

The most important reason for my appearing before you, however, is to ask that all modernization of old buildings be afforded the same treatment as now proposed in the pending bill for elevators and escalators. The very least consideration would be that for central air conditioning, the motors, compressors, fans, coils, ducts, new transformers necessary for the additional power requirement be included with elevators and escalators, as they are, likewise, "closely akin to assets 'accessory to the operation' of a business which presently are eligible for the investment credit." These assets include machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, etc. The House reports also states: "Your committee further believes that new elevator and escalator equipment represents an important aspect of modernization of plant and facilities."

As the pending bill now reads a taxpayer would receive the 7-percent investment credit if air conditioning window units are installed, but if you install central air conditioning to make your building really competitive with the modern structures you will not receive the 7-percent investment credit. This seems to the National Association of Building Owners & Managers to be inconsistent, unfair, and discriminatory against central plant air conditioning and the ownership of buildings. In 1962 central air-conditioning equipment totaled 468,140 units, valued at $288 million.

There is some feeling that maintenance and repair covers many items, but when viewed by the Internal Revenue people, practically all replacement of any consequence must be capitalized, and the item being replaced cannot be considered as fully depreciated because you cannot show the itemized cost of the particular item, as it was part of the original building which must still be depreciated instead of being written off at the end of the actual useful life. It is hard for us to realize under these conditions, where we are operating under a tax shelter.

There is a great deal of modernization to be done all over the United States. A full page advertisement by the United States Steel Corp., in the Wall Street Journal, September 5, 1963, stated, in part as follows:

"The average age of buildings facing remodeling is a tender 15.

"Some are less than a dozen years old, others are old timers.

"For every $3 spent in new building construction today, $1 is spent for remodeling existing structures.

"The 10 buildings shown here are only a few of many recent building rehabilitation jobs."

We feel that rather than being discouraged, this modernization of buildings should be encouraged for the economic welfare of our country.

In conclusion, we most respectfully ask that you give serious consideration to extending the 7-percent investment credit to all modernization of older buildings. At the very least, we would hope that you would consider extending the same treatment to central air-conditioning equipment, including motors, compressors, fans, coils, ducts, cooling towers, and other equipment necessary to its operation, new lighting fixtures, and new transformers for the additional electric load.

We strongly feel that the necessary structural changes for their installation should be also included for escalators and elevators, as well as the other items mentioned above, as the structural changes in some cases are very extensive and most particularly with the installation of central air conditioning.

Although the Treasury Department stated that consideration would be given to new depreciation guidelines for buildings, if section 1250 is enacted (and which has no relationship to an old building), there is no guarantee that this will be done, and we believe that in any event it would not give the incentive for building modernization which I have described, and which should be afforded the 7-percent tax investment credit.

The CHAIRMAN. The next witness is Mr. Richard A. Musgrave of Princeton University. I should say "Doctor."

Take a seat, sir. You may proceed, Doctor.

STATEMENT OF RICHARD A. MUSGRAVE, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY

Mr. MUSGRAVE. Mr. Chairman, I support the bill now before your committee, subject to elimination or amendment of the capital gains provision and I urge its speedy enactment. But in so doing, I must note two concerns. I am critical of some of the arguments with which the fiscal case for tax reduction has been presented; and I believe that this bill should be looked upon largely as a tax reduction, not a structural tax reform. I shall comment briefly on these two aspects.

Unless the case for tax reduction be clearly understood, we shall not learn how to operate fiscal policy properly; and by applying the wrong criteria, we may discredit the effectiveness of the policy even though it works. Most important, misplaced emphasis may permit the expansionary effects of rate reduction to be canceled by offsetting expenditure restraints.

The valid economic case for the proposed tax reduction is based on these three considerations: 1. Notwithstanding a sustained upswing, the economy has not performed to capacity in recent years. In substantial part this has been due to deficient total demand, and in the absence of sustained expansionary measures there is little prospect of better performance.

2. Given the balance-of-payment restraint under which we will operate for sometime, expansionary action must be largely on the fiscal, rather than the monetary side.

3. Expansionary fiscal action may take the form of expenditure increase or tax reduction. Over recent years, the former approach was used, fiscal expansion resulting largely as a by-product of increased defense and space appropriations. Now tax reduction is to be relied upon. This makes sense, because budget expenditures should be determined on their own merits, rather than by compensatory considerations. Moreover, tax rate reduction may help investment incentives.

All this is good economics and I accept it. But this is not all there is to the argument. I also hear, and prominently so, that tax reduction is needed because it is the best way toward a balanced budget. Secretary Dillon has emphasized this aspect in his testimony, and "the intent of Congress" preamble which precedes the House bill, makes it the very focus of the legislation. This is the part of the argument which leaves me worried.

In table 1, I summarize what seems to me the general budget outlook, suggested by Secretary Dillon's statement before this committee and supporting his expectation that the tax cut will lead to a balanced budget by 1968.

Of course, this is my interpretation and he is not to be held responsible for it.

The result which is shown on line 11 follows from two assumptions. One is that further increases in budget expenditures (line 2) will be held to the very minimal limits prescribed by existing programs. The other is that tax receipts will develop most favorably (line 10), reflecting a sustained rise in the level of GNP and corresponding built-in gain in revenue (line 5), as well as a substantial (over 50 percent) recoupment of the gross revenue loss from rate cuts (line 7) through additional expansionary effects on the level of GNP. I do not share these expectations.

The implied expenditure outlook of line 2 is neither realistic nor desirable. While I follow the basic premise of the tax reduction approach, that budget expenditures should be determined on their own merit and not as a make-work device, I also accept the corollary that compensatory fiscal policies should not be permitted to interfere with the rendering of necessary public services. The scope for tax reduction should be set after the proper level of expenditures is determined, and not vice versa.

In a growing economy, a rising level of public services should be forthcoming, going beyond the minimal growth in outlays under existing programs as implied in these figures in line 2. Thus, I believe that the picture of line 2 imposes an undue restraint, and I reject it. The case for efficiency in public expenditure is obvious, and I am as eager to urge it as anyone else. But efficiency does not mean moratorium on new programs or an across-the-board cut. What is needed is a more efficient budgetary and especially legislative procedure.

As for the revenue outlook, I do not believe that the proposed cut, combined with the assumed retardation of expenditure increase, would generate the levels of GNP needed to realize these revenue figures. The implied assumptions regarding increases in GNP which are shown in lines 12 to 14 seem to me too optimistic and to reflect a much exaggerated view of the expansionary powers of the tax cut. I can find little foundation for this view in the behavior of the economy over the last decade.

The fact of the matter is that in recent years a rising level of expenditures has resulted in continued increases in the leverage power of the Federal budget, and the economy has responded well. The tax cut, assuming it to be effective in early 1964, would further boost the expansionary forces of the budget during that year. This will again contribute to sustain the level of economic activity, just as has been the case in recent years.

And the second installment in 1965 would do the same. But after the economy has become adjusted to the tax cut, and assuming the further expenditure increase to be held within the proposed minimal limits, the year-to-year change in the budget will cease to be expansionary and, in view of the built-in rise in tax yield, become restrictive. The basic built-in response of the tax structure to rising GNP will not be reduced greatly by this bill.

This being the case—and I have attempted to support this reasoning in table 2 which I will skip over in this presentation—I do not believe that the favorable GNP forecast, underlying table 1, is consistent with its fiscal policy assumption. For the results of table 1 to come about I would have to assume that the tax cut will transform the climate of investment behavior to a degree which seems to me quite unlikely and quite unprecedented in terms of past experience.

All this, I hasten to add, does not mean that I am against the tax cut. On the contrary, I believe that it is badly needed. But I urge that it be seen in a realistic light, and not as a single-step and cure-all measure. In this growing economy, the budget if left to itself (constant absolute level of expenditures and constant tax rates) generates a restrictive drag of, say, $5 billion a year. Thus, further adjustment is likely to be called for later on.

But, you may wonder, where does this leave us with regard to the public debt? There are two answers to this. One is that the debt may be higher without the tax cut. That is to say, failure to cut taxes may push the economy into a serious recession, which in turn may lead to large deficits, matching or easily surpassing that of 1959. Such may be the case, but I do not like to ride the point, because I do not believe that the economy is precariously balanced between serious recession (which will result without tax cut and lead to a huge deficit) and perpetual prosperity (with full or overrecovery of the revenue loss in the case of a tax cut).

Much more realistic seems to me a situation where a sustained expansionary policy (not a once and for all rate cut but one that may be followed by successive cuts in future years) will have the combined results of modest addition to the deficit, plus a sustained and substantial reduction in the gap between actual and potential output. In an expanding economy, fiscal action may well be needed. But one would have to be extremely pessimistic to expect that the required deficits will be such as to raise the ratio of debt to GNP. And—I am expounding here a basic fact of fiscal economics—it is this ratio of debt to GNP that matters, and not the absolute level of the debt.

I may add that there are few things on which professional economists can speak ex cathedra and say this is simply so, but this is one of the instances where we can.

Finally, a word about the near term outlook for calendar 1964. I am concerned that failure to act promptly on the tax cut, especially failure to make it retroactive to the beginning of 1964, might combine with restraining effects, of the anticipated cut on appropriations and on the expenditure level proposed for fiscal 1965. This might produce a net effect in calendar 1964 which shows little expansion and which may even be on the restrictive side. This may or may not trigger a recession, but it would indeed be an ironic result of a budget policy, undertaken with the very opposite in mind. To ward off such a

danger, I suggest that consideration be given, in view of the delay, to speed up the rate cut beyond the 2-year schedule now contemplated.

I now turn to the matter of tax reform. Tax reform as distinct from general rate reduction, means a change in the distribution of the tax burden among different people. This reallocation may be concerned with improving the economic effects of the tax structure, or it may be aimed at improving equity.

In some instances—for example, the elimination of tax exemption of State-local interest and of special depletion allowances—the two objectives reinforce each other, but in others they may conflict. Both are important, and where conflict exists a solution need be found which is best on both grounds.

To begin with, I wish to emphasize that the equity of the tax structure is an important end in itself. The ability of a people to institute a fair and equitable tax structure is a true test of social responsibility in a working democracy.

Income tax reform, therefore, is not only a matter of broadening the tax base so as to permit rate reduction to aid incentives. If this were the overriding concern, it could be met readily by moving to a gross income tax without exemptions. But such is not the case. Equitable distribution of the tax burden is important. This means an income tax law which defines income so that, in line with the demands of "horizontal equity," people in equal positions are treated in similar fashion. It also means that the tax burden, in line with considerations of vertical equity, should be distributed fairly among different income groups. As most of us see it—and this is a matter more of political philosophy than economic analysis—this requires some degree of progression, especially in the individual income tax, since the rest of the tax structure is regressive.

We have had much discussion of these matters over the last 20 years, including two extensive studies by the Congress, the Joint Economic Committee study of 1955 under the leadership of Senator Douglas, and the Ways and Means Committee study of 1959 under the direction of Congressman Mills.

From these studies, as well as from other writings, there have emerged certain guidelines for tax reform which, among disinterested parties, had found a fair degree of acceptance. There are some elements in the current bill which are in line with this thinking but the degree of progress, realized after all these efforts, is disappointingly small.

Moreover, the capital gains change in the House bill, as distinct from the administration's more balanced proposal, is a move in the wrong direction. If enacted in this version, I would judge the bill's reform value, I am sorry to say, to be on the net loss side.

One of the themes in the case for income tax reform has been the need for eliminating the glaring gap between reality and appearance in the taxation of higher incomes. As shown in the tables submitted by Secretary Dillon,[1] effective tax rates in 1960 ranged from 31.1 percent in the $50,000 to $100,000 bracket, to 32.3 percent in the above $1 million bracket. This contrasts with a range from, say, 45 to 91

[1] See these hearings, vol. 1, p. 278. Not only do average rates rise less than expected, but marginal rates do in fact decline when moving up the income scale. See R. A. Musgrave, "How Progressive Is the Income Tax," Tax Revision Compendium, 1959, vol. 3, p. 2223.

percent which the innocent bystander may deduce from reference to the rate tables. The reason lies largely in the treatment of capital gains, but also involves stock options, State and local interest, and so forth.

Now it is true that plugging these loopholes is relatively unimportant on revenue grounds. But it is important in terms of horizontal equity since some high-income people do pay the statutory rates; also it is vitally important in terms of income tax philosophy in general.

The question of whether and by how much high top bracket rates should be brought down is rightly open to debate and there may be a good case for reduction. But it is difficult to see how reasonable men can reject the principle that such rates as are on the books should be uniformly paid.

What does the current bill accomplish in this respect? The top rate was brought down to 70 percent, the dividend credit was removed and a few rules were tightened, such as personal holding companies and aggregation of mineral properties. But beyond this, little was accomplished to close loopholes.

The administration's suggestions to limit the area of statutory capital gains were largely rejected as in the case of patent royalties, coal royalties, sale of standing timber or livestock, and so forth. To make matters worse, iron ore royalties were added to the eligible list. Fast depreciation was added and such changes in the treatment of stock options as remains in the House bill do little to close this channel of tax avoidance. After all the thinking that has been done on these items, the result is indeed meager and disappointing to all those of us who have put much time and effort in working toward tax reform. I hope that the Senate will do better.

Matters are much the same regarding the fate of the administration's capital gains proposal. This proposal, which combined rate reduction with constructive realization at death, has been converted into rate reduction only. Constructive realization, the only really important reform item, was dropped. With this "reform" (the House version) the rate gap between ordinary income and long-term capital gains would be widened, and the frequent phoniness of high bracket rates would be increased rather than reduced. Some would argue that all this does not matter since the general level of bracket rates has been brought down, but I disagree. Structural income tax reform is not accomplished by moving the rates toward zero. Base reform should go hand in hand with rate reduction; and if Congress believes that remaining rates are still too high to permit a tight base, the public should be told of this, so that there can be further rate reduction combined with a real program of loophole closing.

I now turn to the middle range of the income scale. This is the range where, as pointed out at great length in the various studies, broadening of the tax base could lead to substantial revenue gains. Reference is here to such large items as the standard deduction and the treatment of major itemized deductions such as interest, taxes, and so forth.

A sensible program could be developed in this respect, treating each of these items on its merits, but the practical difficulties of enacting such a measure would have been very great. The 5-percent floor for itemized deductions, contained in the administration proposal, seemed

a fair approximation to such a solution. But as you know, the baby perished in the very delivery room. What remains of it—treating gasoline, liquor, tobacco, and certain other taxes as nondeductible—is welcome, but not enough. There are a few other items in the bill which are also on the welcome list (income averaging, child care provision, employee moving expenses, revised treatment of group term life insurance etc.) but on the whole, the reform fare is again rather meager.

Regarding the lower end of the scale, I applaud the splitting of the first bracket and the further pinpointing of low-income relief through the minimum standard deduction. This approach is much superior to the costly alternative of exemption increase.

In appraising the general pattern of reduction reference must be made, finally, to the net result of base as well as rate changes. The pattern of the House bill, as shown in table 3, is somewhat more favorable to the upper end of the scale, but on the whole it does not differ greatly from the administration proposal.

The reduction may be looked at in a number of ways (cols. I to IV), none of which has logical priority, and in all seems to follow a reasonable pattern. I would emphasize, however, that these ratios do not include the effects of the corporate and capital gains cuts. The distributional effect of the administration's capital gains proposal which matches rate reduction with constructive realization, is difficult to estimate.

Under the House bill, however, we have only the rate reduction on long gains and this clearly favors higher incomes. The corporate cut may be expected to work in the same direction. To give a more comprehensive picture, I have attempted to show a revised distribution, including these two factors. The results are given in table 4. As far as the corporate cut is concerned, I assume it to be reflected in increased profits,[1] which I impute to the shareholder either as increased dividends or capital gains. The tax-reduction benefit assigned to the shareholder equals this addition to his income net of the addition to his individual income tax resulting therefrom. As for the capital gains case, I assume the 1959 ratio of realized gains to total income to prevail, and tax savings equal the reduction in the gains rate applied to these gains. Possible increases in tax liability due to increased realization—induced by higher rates—are disregarded.

The results as shown in table 4, are speculative, but I would consider them more representative of the total picture than the Treasury tables which exclude the corporate and capital gains reduction. Comparing columns III and IV, we note that the high income share in the total reduction is now significantly larger. The percentage reduction in liabilities which in the Treasury tables (col. I) shows a continuous decline when moving up the income scale now is U-shaped (col. II) and rises at the upper end. As noted before, this largely reflects the House bill version of the capital gains change. Personally, I do not consider this a desirable pattern, especially since it is realized through increasingly preferential treatment of gains, rather than through top bracket rate reduction.

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[1] If the corporation tax was shifted into higher prices, and if the rate reduction results in "unshifting," the benefit will go to consumers and will decline as a percent of income, when moving up the income scale. This reverses the pattern of the corporate rate cut and modifies the picture given in footnote table to table 4.

In concluding, let me repeat that I urge speedy enactment of this bill, subject to elimination or amendment of the capital gain provision. Such action will render an important and needed contribution to the strength of our economy. It will also make a modest start toward tax reform, but the major task of structural reform remains ahead and will have to be faced some other day.

Thank you.

(The tables referred to follow:)

TABLE 1.—*Hypothetical budget outlook with tax cut and balance in 1968*

[In billion dollars]

	Fiscal years					
	1963	1964	1965	1966	1967	1968
Expenditures:						
1. Base		92.6	98.0	101.1	103.6	106.1
2. Increase		5.2	2.3	2.5	2.5	2.5
3. Total	92.6	98.0	101.1	103.6	106.1	108.6
Receipts:						
4. Base		86.4	88.8	92.1	96.6	102.6
5. Normal gain		+4.2	+5.0	+6.0	+6.0	+6.0
6. Gross loss (1963 level of GNP)		−2.2	−7.4	−11.1	−11.1	−11.1
7. Recoupment		+.6	+3.9	+6.1	6.1	6.1
8. Net loss		−1.8	−3.5	−5.0	−5.0	−5.0
9. Net loss from tax cut (incremental)		−1.8	−1.7	−1.5		
10. Total (line 4 plus line 5 plus line 9)	86.4	88.8	92.1	96.6	102.6	108.6
11. Deficit (line 3 minus line 10)		−9.2	−9.0	−7.0	−3.5	0.0
Implied gain in GNP:						
12. Normal		+19.0	+23.0	+27.0	+27.0	+27.0
13. Due to tax cut		+2.0	+16.0	+10.0		
14. Total		+21.0	+39.0	+37.0	+27.0	+27.0

Notes to table. All references are to these hearings, vol. 1.

Line 2: Figure for 1965 based on condition that 1965 deficit is below 1964 deficit (see p. 386). Figures for 1966–68 see p. 382.

Line 3: Figure for 1964 derived from line 9 and line 10.

Line 5: Figure for 1964 is residual. Figures for 1965 see p. 135; for 1966–68 see p. 387.

Line 6: Figures for 1964 and 1965, see p. 135. House bill, effective Jan. 1, 1964.

Lines 7 and 8: Figures for 1964 and 1965 see p. 386. Figure for 1966, my estimate.

Line 10: Figure for 1964, see p. 386.

Line 11: Figure for 1964, see p. 385.

TABLE 2.—*Change in fiscal leverage under budget outlook of table 1*

[In billion dollars]

Fiscal year	Increase in budget expenditures I	Change in tax revenue at full employment: Normal growth II	Tax cut III	Net IV	Gain in leverage[1] V
1959	+9.0	+4.6		+4.6	+5.6
1960	−4.8	+4.7		+4.7	−8.3
1961	+5.0	+4.8		+4.8	+1.4
1962	+6.3	+4.8		+5.0	+2.6
1963	+4.8	+4.9		+4.9	+1.1
1964	[2] +5.2	+4.9	[4] −2.2	+2.7	+3.2
1965	[3] +2.1	+5.0	[4] −5.2	+.2	+2.0
1966	[3] +2.5	+5.1	[4] −3.7	+1.4	+1.5
1967	[3] +2.5	+5.2		+5.2	−1.3
1968	[3] +2.5	+5.3		+5.3	−1.5

Explanation:
[1] Col. I minus 75 percent of col. IV.
[2] Current estimate.
[3] Assumed, in line with line 2, table 1.
[4] Gross loss, incremental basis.
Based on growth rate of 3.5 percent and marginal tax rate of 0.23.
Interpretation: Fiscal policy may be considered an expansionary (restrictive) factor in any one year if the leverage exerted at full employment income increases (decreases). This change in leverage is indicated as a first approximation by the budget "multiplicand" defined as expenditure change minus 70 percent of the revenue change, the 70-percent ratio being used to reflect the extent to which payments give rise to reduced private demand. This is the "multiplicand" which is then subject to a multiplier effect. (Note that the appropriate multiplier applicable to col. V is a multiplier without tax leakage and thus substantially larger—in the neighborhood of 6—than the usual net multiplier.) On this basis it will be noted from col. V that fiscal policy was an expansionary factor during 1961–63 and that, assuming the tax cut to be in effect as proposed, it will continue so for 1964 and 1965. Thereafter the gain disappears and becomes negative. Yet, the outlook of table 1 assumes that GNP continues to rise at a substantial rate.

TABLE 3.—*Distribution of tax reduction under administration plan and House bill excluding corporate rate cut and capital gains changes*

[In percent]

Adjusted gross income	Distribution of cut in liabilities I: Administration plan[1]	Distribution of cut in liabilities I: House bill[2]	Percentage cut in liabilities II: Administration plan[1]	Percentage cut in liabilities II: House bill[2]	Number of percentage points by which ratio of tax to income is reduced[3] III: Administration plan	III: House bill	Tax reduction as a percentage of income after tax[3] IV: Administration plan	IV: House bill
Under $3,000	7	6.2	−39	−38.3	−3.1	−3.1	3.4	3.4
$3,000 to $5,000	13	11.9	−28	−26.2	−2.6	−2.5	2.9	2.7
$5,000 to $10,000	44	41.0	−21	−19.9	−2.3	−2.2	2.6	2.5
$10,000 to $20,000	22	23.5	−15	−16.4	−2.3	−2.5	2.7	2.9
$20,000 to $50,000	10	11.5	−12	−15.1	−2.8	−3.5	3.7	4.6
$50,000+	4	5.9	−9	−12.6	−3.5	−4.9	5.7	7.9
Total	100	100.0	−18	−18.8	−2.4	−2.5	2.8	2.9

[1] President's 1963 tax message, hearings before Committee on Ways and Means, pt. I, p. 28.
[2] Revenue Act of 1963, hearings before the Senate Committee on Finance, pt. I, p. 151.
[3] Income, defined as adjusted gross income is estimated by applying tax liability to AGI ratios (from Statistics of Income for 1959) to estimated 1963 liabilities under current law as given on p. 151, these hearings.

TABLE 4.—*Distribution of tax reduction under House bill adjusted to include corporate rate cut and tax reduction on long-term gains*[1]

[In percent]

	Percentage reduction in liabilities		Distribution of reduction in liabilities	
	Treasury estimate I	Adjusted II	Treasury estimate III	Adjusted IV
$5,000	−29.4	−33.2	18.1	16.6
$5,000 to $10,000	−19.9	−21.7	41.6	36.1
$10,000 to $20,000	−16.4	−20.1	23.5	23.3
$20,000 to $50,000	−15.1	−22.9	11.5	14.1
$50,000+	−12.6	−26.0	5.9	9.9
Total	−18.8	−23.0	100.0	100.0

[1] In dealing with the corporate rate cut, the following steps are taken: (1) Allocate revenue loss of $2.3 billion by income brackets according to distribution of dividends (see p. 167, vol. 1 these hearings); (2) divide totals between dividends (62.1 percent) and retained earnings (37.9 percent), the 1960 ratio; (3) for dividend part, impute to each income bracket a tax relief equal to $(1-t_m)\Delta D$, where t_m is the marginal personal (joint return) tax rate (see p. 148, these hearings, vol. 1) and ΔD is the dividend gain; (4) for retained earnings part, impute a "tax relief" equal to applicable capital gains rate reduction (these hearings, p. 199).

In dealing with the capital gains rate cut, we estimate the amounts of long-term gains for income brackets above $5,000 on the basis of the long-term gains to "total realized income" ratios for 1959 as given in these hearings, vol. 1, p. 198. Since the table does not extend to below $5,000, it is assumed that realized long gains under $5,000 are equal in amount to those received by the $5,000 to $10,000 group, an equality which approximately holds for total net gains (long and short) as reported by Statistics of Income for 1959. The tax relief is then estimated by applying the reduction in rate (these hearings, vol. 1, p. 199) to these totals.

Showing the distribution of tax relief for the corporate rate and capital gains cuts separately, we have these results—

[In percent]

	Corporate rate cut I	Capital gains cut II	Total III
Under $5,000	9.8	11.0	10.1
$5,000 to $10,000	17.2	10.5	15.3
$10,000 to $20,000	23.3	20.7	22.5
$20,000 to $50,000	24.2	28.3	25.4
Over $50,000	25.6	29.5	26.7
Total	100.0	100.0	100.0
Net change in liabilities (millions of dollars)	1,499	590	2,089

The CHAIRMAN. Thank you very much, Dr. Musgrave.

Senator Douglas?

Senator DOUGLAS. I want to congratulate Professor Musgrave on his testimony which, I think, is excellent.

I would like to start off by addressing my questions to table IV in your statement.

First, I want to commend you for trying to consolidate the distributional effect of the reduction in corporate tax and the reduction in long-term captial gains tax along with the reductions in the individual income taxes. The figures presented, orginally presented, by the Treasury have confined themselves to the distribution effects of the individual income taxes. I have been pushing them constantly to include in their computations corporate taxes, and also the effect of capital gains which helped to change the story very markedly.

I wonder if you would explain what the successive columns mean.

Mr. MUSGRAVE. Yes, sir.

Senator DOUGLAS. In table IV, for the record.

Mr. MUSGRAVE. Yes, sir.

Looking at table IV, column I is the Treasury estimate of the percentage reduction.

Senator DOUGLAS. You mean on individual income taxes.

Mr. MUSGRAVE. Yes. This is the Treasury's estimate of the individual income tax only.

Senator DOUGLAS. Columns I and III.

Mr. MUSGRAVE. The two columns marked I and III are the Treasury estimates for the individual income tax only, column I giving the percentage reduction in liabilities, and column III giving the percentage distribution of the reduction in liabilities.

Senator DOUGLAS. Yes.

Mr. MUSGRAVE. The two columns marked II and IV give the corresponding patterns——

Senator DOUGLAS. After taking into account——

Mr. MUSGRAVE. The long-term capital gains and the corporate rate cut.

Senator DOUGLAS. I see.

Then that shows that the decrease in liabilities is still, the percentage reduction in liabilities is still the greatest for those under $5,000, and then is approximately constant up to $50,000, and increases beyond $50,000.

Mr. MUSGRAVE. Yes, sir.

Senator DOUGLAS. It is, in a sense, saucer shaped.

Mr. MUSGRAVE. U-shaped.

Senator DOUGLAS. Not quite U; it is a saucer, is it not?

Mr. MUSGRAVE. Yes.

Senator DOUGLAS. Now, what does this refer to, is this a reduction in taxable income?

Mr. MUSGRAVE. No. This is the percentage reduction in liabilities experienced.

Senator DOUGLAS. You mean the amount which you have to pay in taxes.

Mr. MUSGRAVE. Right.

Senator DOUGLAS. The amount which you have to pay in taxes.

Mr. MUSGRAVE. I have made these estimates in a way which might be called rather conservative in the sense that I have given the dividend recipient, the shareholder, only such gain as is left after deducting his increase in personal income tax. In other words, it is a net gain.

Senator DOUGLAS. You do not include the appreciation of the stock due to reinvestment of part of the corporate profits.

Mr. MUSGRAVE. I do.

Senator DOUGLAS. You do?

Mr. MUSGRAVE. Yes, sir. I take the reduction in the corporate tax liability which I say equals the initial increase in profits. This increase in profits, to some extent, goes to dividend distribution, and the shareholder will gain to the extent of his additional dividends, minus his additional income tax liability thereon, and to some extent it goes into capital gains.

Senator DOUGLAS. Take columns III and IV, they deal with the total reduction in dollar terms of taxpayments.

Mr. MUSGRAVE. Right.

Senator DOUGLAS. And indicate the percentage which each group, each income group receives of this total reduction.

Mr. MUSGRAVE. Right.

Senator DOUGLAS. This shows that the group over $50,000, instead of getting only 5.9 percent of the total reduction in tax liability, get 9.9 percent or, in effect, 10 percent rather than 6 percent, is that right?

Mr. MUSGRAVE. Right, quite correct.

Senator DOUGLAS. And the group from $20,000 to $50,000, instead of getting 11.5 percent, receive 14.1 percent or consolidating these figures, instead of the group over $20,000 getting 17.4 percent, they will receive 24 percent.

Mr. MUSGRAVE. Twenty-four percent.

Senator DOUGLAS. Yes.

Mr. MUSGRAVE. Senator Douglas, you understand, of course, that these estimates are somewhat speculative.

Senator DOUGLAS. I understand.

Mr. MUSGRAVE. But I think they are more representative than giving the picture without including them.

Senator DOUGLAS. As a matter of fact, I was getting up a comparison of precisely this point, and I am going to compare that with your results and see how closely they coincide.

But I think the general conclusion that you come to is correct, namely, that the reductions in the corporate taxes and in the long-term capital gains help to offset a good deal of what has been claimed to be the progressivity of the changes in the individual income tax.

Mr. MUSGRAVE. It surely works in that direction.

Senator DOUGLAS. Dr. Musgrave, I was greatly interested in the work which you have done in previous years on the total tax structure of the Nation and, as I remember it, including State and local taxation and, as I remember it, your last results show something of a U-shaped curve, but over the great range of incomes, that if you include the excise taxes and, I think, general sales taxes, that it is approximately proportional.

Mr. MUSGRAVE. Over a wide range.

Senator DOUGLAS. Yes; and that, therefore, the progressive nature of the Federal income tax is almost completely offset by the regressive nature of State and local taxation; is that correct?

Mr. MUSGRAVE. That is correct.

Senator DOUGLAS. Except in the extremely low incomes where the rate goes down, and the extremely high incomes where the rates goes up, is that true?

Mr. MUSGRAVE. That is correct.

Senator DOUGLAS. Did you take actual amounts paid or nominal tax rates?

Mr. MUSGRAVE. We allocated—we tried to estimate the allocation of actual payments made.

Senator DOUGLAS. I see.

Mr. MUSGRAVE. I have, if I may say, two new ideas on this.

Senator DOUGLAS. Don't make it too complicated.

Mr. MUSGRAVE. No. Let me just mention them. One is that I recently had a student of mine do a Ph. D. dissertation which tries to take public expenditures into the picture on the same basis and get

what you might call a net benefit, in other words, try to allocate expenditures and deduct tax burdens from expenditure benefits.

If you do this, you get a rather different pattern because you find that at the State and local level the benefits are overwhelmingly propoor, if you wish, and this indeed more than offsets——

Senator DOUGLAS. You mean on health and education.

Mr. MUSGRAVE. Yes; and this more than offsets, as it were the antipoor State and local tax pattern. This is one thought.

The other one is that we did a study which was just published by the Hopkins Press on the incidence of the corporation tax which seems to suggest——

Senator DOUGLAS. Just one question. The progressive nature of the Federal income tax is under heavy attack, as you know, at the present time. There are some who would eliminate it completely; and then when pressed, they simply are against the regressive feature of the Federal income tax, and say what we should have is a proportional Federal income tax. When this is combined with the regressive system of State and local taxes would this not produce a regressive overall rate?

Mr. MUSGRAVE. Yes, it undoubtedly would. With the income tax, there are these two aspects:

As far as the great mass of taxpayers are concerned, say people with incomes under $10,000, what really makes the income tax progressive is the exemption. It is this zero bracket rate that makes the income tax progressive for 75 percent of our taxpayers. It is the existence of the exemption that distinguishes it from a gross income tax without exemption. The high bracket rates, let us say, for incomes over $50,000 are a different problem referring to a much smaller group.

Senator DOUGLAS. For the sake of the record, let me say, I tended to identify sales taxes with State and local taxation but, of course, I believe we raise now something like $12 billion a year from Federal excise taxes which are manufacturers' sales taxes. These also are regressive, are they not, since they fall primarily on liquor and tobacco, and then gasoline and other items; isn't that correct?

Mr. MUSGRAVE. That is correct.

Senator DOUGLAS. I want to commend you on this testimony. I like especially your viewing the tax structure overall and not confining yourself to merely an examination of the individual, of the individual Federal income tax rates.

Mr. MUSGRAVE. Yes.

Senator DOUGLAS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Doctor.

Senator Williams?

Senator WILLIAMS. Doctor, I have one question. I notice you have endorsed this bill subject to the elimination of the amendment on the capital gains provision. Now, in the event that there is no change made in this bill as it relates to capital gains treatment, my question is: Would you favor the enactment or the defeat of this legislation?

Mr. MUSGRAVE. I was afraid that I would be asked this. I have to measure what is the long-run damage to the tax structure against what would be the short-run damage to economic activity. What I have to ask myself is, Am I willing to pay $25 billion worth of GNP

for a damage to the equity of the tax structure which may be with us for a long time?

Senator, the value which I put on these two things is a personal evaluation. I think I would be for the tax cut, but very unhappily so, very unhappily so.

Senator DOUGLAS. Would the Senator yield a minute?

Senator WILLIAMS. Surely.

Senator DOUGLAS. You may avoid passing judgment on this question, but we probably cannot avoid it.

Mr. MUSGRAVE. I am not a Senator. [Laughter.]

Senator WILLIAMS. I understand that you have answered the question, and if I understood it correctly there, you said you would prefer this being eliminated, but if it is not eliminated, as I understand your answer, you would support the bill as it passed the House even with that objectionable feature from your standpoint in there; is that correct?

Mr. MUSGRAVE. In the end I think I would; yes.

Senator WILLIAMS. Thank you.

One other question, speaking of the reforms, would you favor the administration's proposal for the elimination of the unlimited charitable contributions?

Mr. MUSGRAVE. Yes, sir.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS. Now suppose the 4-percent dividend credit is reinstated. How would you, if you were a Senator, how would you vote for the total tax bill then?

Mr. MUSGRAVE. I would, from the beginning, have much favored to go ahead with a simple across-the-board rate cut. We could have done this 2 years ago and never started to tie in the whole question of structural tax reform with the reduction.

Now, the question is what kind of rate cut this would have left me with? Suppose the reduction in the top bracket would have been to, say, 75 percent——

Senator DOUGLAS. I do not understand the answer.

Mr. MUSGRAVE (continuing). I would be in favor of the bill even then; but I assume that an adjustment would be made in the extent to which the top rates are cut.

Senator DOUGLAS. Suppose the adjustment is not made. Would you take the 70 percent and the 4 percent dividend credit, if that is retained, which is very likely to happen, and when the roll is called, and you cannot say, "I want time to consider this," you have got to answer "Yes" or "No."

Mr. MUSGRAVE. At some point I obviously have to start voting against the bill.

Senator DOUGLAS. What?

Mr. MUSGRAVE. At some point I have to start voting against the bill.

Senator DOUGLAS. You mean at some point you have to start voting for the bill?

Mr. MUSGRAVE. No, voting against it. At some point I have to start voting against it. It seems to me that introducing the capital gains change is worse than keeping the dividend credit in the picture because this is——

Senator DOUGLAS. Suppose it is retained and the dividend credit is retained, all these things happen. It is not a question of which is worse, but the two are cumulative, and other things are added.

Mr. MUSGRAVE. I find it very difficult to say that 750,000 people have to be unemployed because I want to insist on this equity matter. This is a hard decision to make. I think I would pass the bill and then I would go out and tell the people that this has been a retrogression in the tax structure, and it has not been responsible——

Senator DOUGLAS. What effect would that have about going out and telling the people?

Mr. MUSGRAVE. Senator Douglas, I am not a statesman. I do not see how I can give comfort——

Senator DOUGLAS. In other words, you are so absorbed—perhaps this is an unjust attribution to you, but I will put it this way—a great many economists are so absorbed in the three-finger exercise on the piano, testing the Keynesian theories, that they forget everything about justice. I do not charge you with that, but I will say a good many economists do.

Mr. MUSGRAVE. My primary function is to tell you how many additional people would be unemployed if we do not have the tax cut, and to say that if you have these structural changes, equity is helped or equity is damaged. Weighing these two things against each other is not something that I can do as an economist. As a citizen, I would go quite a ways to have the rate reduction because of the employment effect.

Senator DOUGLAS. I take it no matter how bad the bill is from the equity standpoint you would be for it because of the alleged stimulative effect.

Mr. MUSGRAVE. No, sir. I think that is unfair. I do not say no matter how bad it is. I think somewhere a line has to be drawn. I would add that I am more upset about the capital gains change than I would be about keeping the dividend credit in.

Senator DOUGLAS. Mr. Chairman, thank you.

The CHAIRMAN. Thank you very much, Doctor. We are glad to have had you, sir.

The next witness is Mr. Joseph A. Pechman, of the Brookings Institution. Take a seat. Should I call you "Doctor"?

Mr. PECHMAN. I prefer "Mister."

The CHAIRMAN. All right. Take a seat.

STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. PECHMAN. Mr. Chairman, I might save the committee some time by suggesting that my formal statement be put into the record and that I summarize the statement briefly, calling attention to the highlights.

The CHAIRMAN. Without objection that will be done.

Mr. PECHMAN. I am very pleased to have this opportunity to appear before the committee to discuss this extremely important tax bill.

In my statement I discuss the need for tax reduction in the present circumstances, and present my views on the major reform features of the bill.

Briefly stated, I believe it is urgent on economic grounds to make a significant reduction in the ratio of Federal taxes to expenditures, and I would urge the adoption of the present bill if the capital gains provisions were removed from it.

In order to avoid the suspense, Mr. Chairman, let me answer the question that was posed to Mr. Musgrave. I would veto the bill as it is now. I think that the tax reduction is very important and I do value $30 billion of GNP that this bill would generate. But I would veto the bill because the capital gains provisions in it are a step in the wrong direction.

If the President were faced with this problem, he could tell the Congress that he regarded this tax bill as inequitable and that the Congress should enact in its place a flat four-point reduction in individual income tax rates, which would reduce individual income tax liability by $8 billion, and a flat four-point reduction in the corporate rates which would reduce the corporate tax liability by another $2 billion. This would provide about the same net reduction as the present bill does.

I do not think there is any conflict between economics and equity in this case. The economic objective can be achieved very quickly by a quick flat-rate reduction clear across the board. The equity objective will take much longer to implement. It requires a great deal of consideration on the part of two big committees; it requires the efforts of many people on the Treasury staff and on the joint committee staff; and it has to be carefully considered.

However, I hope that the committee will seriously consider the capital gains provisions and eliminate them from the bill. This would make the bill acceptable from both the economic and equity standpoints.

Regarding fiscal policy, I will not repeat what has already been said by two experts about as well or better than I have been able to say it. I want to call attention to the paragraph in which I say that I realize that there is great concern both inside and outside of Congress about the succession of budget deficits in recent years. I believe, however, that the best chance we have of breaking this sequence is to get back to full employment as quickly as possible; and I believe that the quickest way to get back to full employment now is to reduce taxes by a substantial amount.

In the fiscal years 1947 through 1957, when unemployment averaged 4.2 percent, the Federal Government ran a cumulative cash surplus of over $20 billion, and the administrative budget was almost precisely in balance for the entire period. As a matter of fact, the actual figure was a small surplus of $75 million.

So that in the entire postwar period up to fiscal year 1957, the Federal Government did not run a net deficit.

For the fiscal years 1958 through 1963, when unemployment averaged 5.9 percent, there were cumulative deficits amounting to $26 billion in the cash budget and $30 billion in the administrative budget.

The lesson, to my mind, is very clear: excessive unemployment creates budget deficits, while full employment ordinarily will generate the surpluses that are needed to reduce the national debt. I think a substantial tax reduction should be enacted because it will give us a very substantial push toward full employment.

In the second part of my statement I take up the tax reform features of the bill. Many people have been rather disdainful of what has been accomplished. I would like to say that I think the House Ways and Means Committee has done a fairly good job. Unfortunately, the bill, as passed, is only a pale shadow of the original proposals. But with the exception of the capital gains provisions which I have already indicated, it is unfair to say that the tax reforms remaining in the bill are inconsequential.

I enumerate five reforms that are important. One is the repeal of the dividend credit; two is the elimination of some unnecessary personal deductions; three is the minimum standard deduction; four is income averaging; and five, revision of the stock option provisions. I have some comments in my statement on how I would improve these provisions, but on the whole they are very good. In addition to these key provisions, there are others that I have not spelled out in detail that are worthwhile.

Although none of these provisions is, in itself, very dramatic, they all warrant adoption. But it is regrettable that the commendable reforms I have just mentioned are combined in the same bill with a wholly unjustifiable reduction in the capital gains tax.

At the present time, capital gains on assets held longer than 6 months are taxed at half the ordinary income tax rates up to a maximum of 25 percent. The bill goes even further and reduces the tax on capital gains held longer than 2 years to 40 percent of the tax on ordinary incomes up to a maximum of 21 percent.

This extraordinary action is a remnant of a proposal by the administration which would have traded a substantial improvement in the capital gains tax structure for a reduction in the capital gains rate. You have already had a discussion with Dr. Hellmuth about this, and I won't repeat what was said.

A reduction in the capital gains tax, particularly of the type included in the bill, would be unwise for several reasons, in my view.

First, capital gains are concentrated heavily in the higher income classes. In 1960, individuals with adjusted gross incomes below $5,000 accounted for 17 percent of long-term capital gains, while those with incomes above $25,000 accounted for 48 percent. The bill provides very large rate reductions for ordinary incomes in the top brackets. A simultaneous reduction in the capital gains rate would unbalance what would otherwise be a reasonably fair distribution of the tax cut by income classes. I think Professor Musgrave's table IV shows this very, very well.

Senator DOUGLAS. Have you had a chance to study that table, sir?

Mr. PECHMAN. Just briefly this morning, and while I have not made the exact calculations, they certainly seem to be in about the right direction.

Senator DOUGLAS. Thank you.

Mr. PECHMAN. I think the saucer-shape point you mentioned, Senator Douglas, is quite correct.

Second, the preferential treatment of capital gains encourages tax avoidance, either through the conversion of ordinary income into capital gains or through the passage of legislation to include ordinary incomes under the capital gains umbrella. Even the bill you are now considering adds one more item, iron ore royalties, to the growing

list of items which are granted capital gains treatment. While it is true that these royalties would be eligible only for the current capital gains rates and not the new ones provided under the bill, it won't be long before these and other taxpayers will be clamoring to be allowed to come in under the new rates. The only way to stop this kind of tax avoidance is to narrow, and eventually eliminate, the differential between the ordinary tax rates and the capital gains rates. There is certainly no reason to widen the differential, particularly when rates in all income classes are being reduced by an average of 20 percent.

Third, although one of the alleged purposes of the rate reduction for capital gains is to unlock assets which are held in portfolios because of the desire to avoid tax, this bill would further aggravate the locking-in effect by adding a new holding period for assets held between 6 months and 2 years.

Finally, because I have spent a great deal of my professional career on technical tax matters, and very few people would tend to call the committee's attention to technical matters, I should like to point out that the bill would create a new category of capital gains which would complicate the income tax unnecessarily. These complications will arise in all cases where the code makes some differentiation between capital gains and ordinary incomes; for example, where losses are carried over from one year to the next, first against capital gains and then against ordinary income; where ordinary incomes are to be averaged while capital gains are not; and so on. To illustrate some of the complications, I refer you to the following explanation of the calculation of the offset of capital losses against the various types of capital gains, which is contained in the report of the Ways and Means Committee.

> [The bill] provides that net class A losses are to be taken into account first and that such losses are first to reduce net class B capital gain and then to the extent of any remaining loss to reduce any net short-term capital gain. Next, net class B losses are to be taken into account, and they are to be applied first against net class A gain and then against any net short-term capital gain. Finally, net short-term losses are to be taken into account, and they are to be applied first against any net class B capital gain and then against any net class A capital gain. This provides an orderly manner for taking into accout various types of losses * * *.

Senator DOUGLAS. Mr. Pechman, what does that mean?

Mr. PECHMAN. I think I know what it means, but I would have a great deal of difficulty to explain it.

The point I am making in referring to this quote is that the capital gains schedule that you and I see when we make out our tax returns is already extremely complicated and difficult to understand. I assure you that it will be absolutely incomprehensible to all but a few experts after it has been revised to incorporate the provisions proposed in the bill.

In summary, the capital gains provisions are a major step in the wrong direction, and they should be eliminated. In my view, this one retrogressive step would outweigh all of the progress made on other aspects of the tax structure in this bill, and for this reason I would not support it. I agree with the Secretary of the Treasury that the committee should eliminate this feature of the bill. If this were done, the bill would make a significant contribution to the economic welfare

of the Nation and also make a constructive step toward improving the fairness of the income tax.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Pechman. Any further questions?

Senator DOUGLAS. Of course, you are aware that the Secretary of the Treasury, in response to a question which I addressed to him, said that even if the capital gains provisions were not eliminated, he still would recommend that the President sign the bill.

Mr. PECHMAN. I think the Secretary of the Treasury knows that I disagree with him on this point.

Senator DOUGLAS. I have no further questions.

The CHAIRMAN. Thank you very much.

Senator DOUGLAS. It is very good testimony, as usual.

Mr. PECHMAN. Thank you, sir.

(The prepared statement of Mr. Pechman follows:)

STATEMENT BY JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION ON THE TAX REDUCTION-TAX REFORM BILL

I am pleased to have this opportunity to appear before the Senate Finance Committee to discuss the extremely important tax bill which it is now considering. I shall discuss the need for tax reduction in the present circumstances, and present my views on the major reform features of the bill. Briefly stated, I believe it is urgent on economic grounds to make a significant reduction in the ratio of Federal taxes to expenditures; and I would urge the adoption of the present bill if the capital gains provisions were removed from it. These views are, of course, my own and do not necessarily represent those of the trustees, officers, or other staff members of the Brookings Institution.

THE NEED FOR TAX REDUCTION

The basic justification for reducing taxes at the present time is that present policies show no promise of breaking through the 5½ percent unemployment barrier which has plagued the Nation for so long. With the resources now available, the U.S. economy could produce at least $30 billion more goods and services per year than it is now producing. But it is clear that, without an additional stimulus from the Federal Government, private demand will not be sufficient to close the large and persistent gaps in employment and output.

The disappointing performance of the economy goes back more than 6 years. We last achieved 4-percent unemployment during the expansion which ended in mid-1957. Since then, there have been two brief and mild recessions when unemployment reached 7 percent or higher. The best we could do following the recovery from the 1957–58 recession was an unemployment rate of 5 percent; and, as I have already said, we have not been able to get below 5½ percent in the current recovery from the 1960–61 recession.

The persistence of the unemployment problem indicates that there is something wrong with the policies pursued in recent years to promote an adequate rate of growth of overall demand by consumers, businessmen, and Government. If the shortage of demand were a temporary phenomenon, excessive unemployment would long since have disappeared. I believe that we have not been able to cope with this problem because our thinking is still geared to fighting an inflation that terminated 6 years ago. Tight budgets and tight money were called for in the late 1940's and early 1950's when demand was pressing hard on capacity. Now the situation calls for fiscal and monetary ease; and since the balance-of-payments problem ties our hands on monetary policy, the only alternative open to us is to use fiscal policy. Admittedly, there has been some easing of fiscal policy since 1960, but it clearly has not been enough.

The additional fiscal stimulus that is needed can be achieved—in principle, at least—from both sides of the budget: through a rise of expenditures, or a tax reduction, or a combination of both. Whatever action is taken, the net result must be a reduction in the ratio of taxes to expenditures. My own view is that it would be in the national interest to expand a number of Federal programs,

particularly in education. However, expenditure policy should be geared primarily to the longrun needs of the economy and to the demand for public services, and it would be unwise to increase expenditures sharply in the interest of demand stimulation. Furthermore, there is no indication that there is a willingness either on the part of the administration or the Congress to initiate enough new programs that would be justifiable on their own merits and would also provide the necessary fiscal stimulus through the expenditure side of the budget alone. Under the circumstances, the modest rise in expenditure now projected in the budget must be supplemented by a tax cut if the economy is to achieve reasonably satisfactory levels of employment in the foreseeable future.

No economist can tell you exactly how much tax reduction is needed. But with an output gap of $30 billion, the $11 billion cut provided in the proposed tax bill—spaced as it is in two installments over a period of 12 months—surely is not excessive. As a matter of fact, it will be grossly deficient if the effect of the cut is neutralized by offsetting expenditure reductions. Every dollar of expenditure reduction would offset the stimulating effect of something more than a dollar of tax reduction. Consequently, the size of the tax cut needed to reach full employment would increase by more than the cut in expenditure.

I realize that there is great concern both inside and outside of Congress about the succession of budget deficits in recent years. I believe, however, that the best chance we have of breaking this sequence is to get back to full employment as quickly as possible. In the fiscal year 1947 through 1957, when unemployment averaged 4.2 percent, the Federal Government ran a cumulative cash surplus of over $20 billion, and the administrative budget was almost precisely in balance for the entire period (the actual figure was +$75 million). For the fiscal years 1958 through 1963, when unemployment averaged 5.9 percent, there were cumulative deficits amounting to $26 billion in the cash budget and $30 billion in the administrative budget. The lesson of these figures is clear: Excessive unemployment creates budget deficits, while full employment ordinarily will generate the surpluses that are needed to reduce the national debt.

THE TAX REFORM FEATURES OF THE BILL

In January of this year, the administration submitted to the Congress an extensive series of tax reforms to accompany the tax reductions it proposed. The tax reform part of the bill which was passed by the House is only a pale shadow of the original proposals. Nevertheless, with the exception of the capital gains provisions, which I will discuss shortly, it is unfair to say that the tax reforms remaining in the bill are inconsequential.

It seems to me that the following five provisions contribute to the objectives of broadening the tax base and improving the equity of the income tax:

1. *Repeal of the dividend credit.*—This provision, which was enacted in 1954, provides a tax credit for 4 percent of dividends received by individuals in all income brackets. It was justified as a method of reducing the so-called double taxation of dividends. In fact, it provides the smallest proportionate reductions in the lowest income brackets where double taxation is heaviest and the largest reductions to persons in the highest brackets where the double taxation is lightest. The Senate has voted repeal of the credit on several occasions during recent years, and I hope it will reaffirm its previous position on this issue in acting on the current tax bill. Unfortunately, the House raised the $50 exclusion for dividends to $100, which is a step in the wrong direction. The income tax would be better off—from the standpoint of equity and simplicity—with both the credit and the exclusion removed. The proposed reduction in the corporate rate moves in the direction of reducing the double taxation of dividends without favoring one group against another.

2. *Elimination of unnecessary personal deductions.*—Most of the personal deductions under present law are not essential for equitable income taxation, yet we allow more than $50 billion to be deducted annually for these purposes. The House has reduced this leakage from the tax base by eliminating the deductions for State and local taxes other than income, sales and property taxes; and also by confining the deduction for casualty losses to amounts in excess of $100. These revisions will raise $570 million of revenue per year and also simplify compliance and administration. The only change I would propose here would be to make the floor for casualty losses somewhat more restrictive by permitting deductions for amounts exceeding $100 or 2 percent of adjusted gross income, whichever is higher, on the ground that the degree of hardship depends on the relative rather than the absolute size of the loss.

3. *The minimum standard deduction.*—The price level has increased substantially since the present personal exemptions were adopted in 1948. However, an adjustment of the exemptions has been deferred because it would involve substantial revenue losses. The minimum standard deduction is a method of confining the increase in exemptions to persons with very low incomes. The revenue loss is estimated at $320 million per year, and more than four-fifth of it would go to persons with incomes below $5,000.

4. *Income averaging.*—By applying the full graduated rates without permitting averaging of years of low and high incomes, the tax law has always discriminated against persons with highly fluctuating incomes. The bill introduces a general averaging system into the individual income tax structure for the first time. This provision will improve the equity of the income tax and increase incentives to undertake risky investments that involve highly variable incomes.

5. *Stock options.*—The bill would tighten the eligibility provisions for the preferential treatment now accorded to stock options. The basic idea of the new provisions is that stock options are a privilege which should be accorded favorable treatment only when it is used for incentive purposes, and that the opportunities for manipulation and abuse should be eliminated. My own view is that the incentive aspect would not be curtailed seriously, and equity would be better served, if the House bill were revised to tax at ordinary income tax rates any spread between the purchase price and option price on the date a stock option is exercised.

In addition to these key provisions, the bill permits deductions for employees' moving expenses incurred as a result of a change in employment; restricts the sick pay exclusion to persons who are ill more than 30 days; closes a number of loopholes in the personal holding company provisions; taxes to the employee the cost of group term life insurance protection purchased for him by his employer to the extent that it exceeds $30,000; simplifies the investment credit; provides for current payment of income taxes by large corporations after a period of transition; and prevents excessive corporation surtax benefits to firms through multiple incorporation. Although none of these provisions is in itself very dramatic, they are all very much worthwhile and warrant adoption.

THE CAPITAL GAINS PROVISIONS

It is regretable, however, that the commendable reforms I have just mentioned are combined in the same bill with a wholly unjustifiable reduction in the capital gains tax. At the present time, capital gains on assets held longer than 6 months are taxed at half the ordinary income tax rates up to a maximum of 25 percent. The bill goes even further and reduces the tax on capital gains held longer than 2 years to 40 percent of the tax on ordinary incomes up to a maximum of 21 percent.

This extraordinary action is a remnant of a proposal by the administration which would have traded a substantial improvement in the capital gains tax structure for a reduction in the capital gains rate. The proposal was to tax the accrued capital gains transferred at gift or death as if they were realized. The omission of any tax on such gains is undoubtedly the weakest link in the entire individual income tax, since it provides a powerful incentive for individuals to hold on to their assets indefinitely and thus becomes a loophole for the escape of many billions of dollars of income from taxation each year. To close the loophole, President Kennedy agreed to reduce the capital gains rate to 30 percent of the rates on ordinary incomes. In making this recommendation, he cautioned that, in the absence of constructive realization, "there would be no justification for any reduction in present capital gains rate schedules." However, after experimenting with a very weak alternative to constructive realization, the Ways and Means Committee finally decided to do nothing about capital gains transferred at gift and death but retained a reduction in capital gains rates for assets held more than 2 years.

A reduction in the capital gains tax, particularly of the type included in the bill, would be unwise for several reasons:

First, capital gains are concentrated heavily in the higher income classes. In 1960, individuals with adjusted gross incomes below $5,000 accounted for 17 percent of long-term capital gains, while those with incomes above $25,000 accounted for 48 percent. The bill provides very large rate reductions for ordinary incomes in the top brackets: a simultaneous reduction in the capital gains rate would unbalance what would otherwise be a reasonably fair distribution of the tax cut by income classes.

Second, the preferential treatment of capital gains encourages tax avoidance either through the conversion of ordinary income into capital gains, or through the passage of legislation to include ordinary incomes under the capital gains umbrella. Even the bill you are now considering adds one more item—iron ore royalties—to the growing list of items which are granted capital gains treatment. While it is true that these royalties would be eligible only for the current capital gains rates and not the new ones provided under the bill; it won't be long before these and other taxpayers will be clamoring to be allowed to come in under the new rates. The only way to stop this kind of tax avoidance is to narrow, and eventually eliminate, the differential between the ordinary tax rates and the capital gains rates. There is certainly no reason to widen the differential, particularly when rates in all income classes are being reduced by an average of 20 percent.

Third, although one of the alleged purposes of the rate reduction for capital gains is to unlock assets which are held in portfolios because of the desire to avoid tax, this bill would further aggrevate the "locking-in" effect by adding a new holding period for assets held between 6 months and 2 years.

Finally, the creation of a new category of capital gains will complicate the income tax unnecessarily. These complications will arise in all cases where the code makes some differentiation between capital gains and ordinary incomes, e.g., where losses are carried over from 1 year to the next, first against capital gains and then against ordinary income; where ordinary incomes are to be averaged while capital gains are not; and so on. To illustrate some of the complications, I refer you to the following explanation of the calculation of the offset of capital losses against the various types of capital gains, which is contained in the Report of the Ways and Means Committee on H.R. 8363 (p. 98):

"[The bill] provides that net class A losses are to be taken into account first and that such losses are first to reduce net class B capital gain and then to the extent of any remaining loss to reduce any net short-term capital gain. Next, net class B losses are to be taken into account and they are to be applied first against net class A gain and then against any net short-term capital gain. Finally, net short-term losses are to be taken into account and they are to be applied first against any net class B capital gain and then against any net class A capital gain. This provides an orderly manner for taking into account various types of losses * * *."

The capital gains schedule is already extremely complicated and difficult to understand. I assure you that it will be incomprehensible to all but a few experts after it has been revised to incorporate the provisions proposed in the bill.

In summary, the capital gains provisions are a major step in the wrong direction and they should be eliminated. In my view, this one retrogressive step would outweigh all of the progress made on other aspects of the tax structure in this bill. For this reason, I agree with the Secretary of the Treasury that the committee should eliminate this feature of the bill. If this were done, the bill would make a significant contribution to the economic welfare of the Nation and also make a constructive step toward improving the fairness of the income tax.

The CHAIRMAN. Our next witness is Victor Paul on behalf of the committee for repeal of the Federal retail excise tax.

Please proceed, Mr. Paul.

STATEMENT OF VICTOR PAUL ON BEHALF OF THE COMMITTEE FOR REPEAL OF THE FEDERAL RETAIL EXCISE TAX

Mr. PAUL. My name is Victor Paul, I am chairman of the board of Wiss Jewelry Co., operating four retail stores in New Jersey. I appear on behalf of the committee for repeal of the Federal retail excise tax. The committee is made up of the following trade groups:

National Retail Merchants Association.
Retail Jewelers of America, Inc.
Manufacturing Jewelers & Silversmiths of America, Inc.
Sterling Silversmiths Guild of America.
Associated Fur Manufacturers, Inc.

Luggage & Leather Goods Manufacturers of America, Inc.
National Wholesale Jewelers' Association, Inc.
National Retail Hardware Association.
Toilet Goods Association, Inc.
National Authority for Ladies' Handbags Industries.

We are not here to ask for favored treatment or special privilege, but rather to ask you to end a glaring inequity in our tax structure—an inequity that prevents the industries I represent from contributing their full share to the goal of more jobs and an improved economy. My statement will cover four brief points and will, I hope, make certain incontrovertible facts clear to the committee—facts which indicate that the Federal retail excise tax inhibits the growth of our industries; facts which show that this tax is discriminatory and unfair; facts which show that repeal of this business depressing tax will create jobs and substantially benefit the economy.

1. The retail excise tax, a so-called temporary tax was imposed on a limited number of products during World War II. It was then deemed expedient for the good of the country to divert consumer spending and to put a brake on the production and sale of certain items in order to curtail the use of material and labor.

This is supported by a statement made on two separate occasions to the House Committee on Ways and Means by the former Director of the Office of Price Administration. I quote first from his testimony in 1941:

> Turning first to the proposals for excise taxes, the only case which may be made out for such additional taxes at the present time from a total defense point of view must rest upon its effectiveness in discouraging civilian production which competes with the defense program for men, materials, and machines.

In 1950 this same Government official testified as follows:

> I came then (referring to 1941) to urge selection and imposition of the excise taxes because I reasoned they had the power to restrain and divert. I come today to urge repeal for exactly the same reason. I have seen their power to restrain and divert.

The administration has proposed and it appears the Congress may reduce taxes. In view of these actions, we submit the Congress has a moral obligation to repeal the wartime-imposed "temporary" Federal retail excise tax at least at the same time, if not before, it reduces other taxes which are a permanent part of our tax laws. How else can trust in Government promises be maintained?

2. Repeal will, for the first time since pre-World War II, place our products on an equal basis with other products now competing for consumer preference, and will remove the Government from the untenable position of influencing consumer selection of the types of goods and services for which he wishes to spend his money.

The Federal retail excise tax discriminates severely against the products produced and sold by several hundred thousand persons in every community in the Nation. Resulting inconsistencies are legion but a few examples suffice to illustrate the point.

A woman may spend many hundreds of dollars—yes, thousands—on elaborate ball gowns free of special tax; yet the most modest of handbags is subject to the Federal retail excise tax.

A woman's cloth coat costing hundreds of dollars is not taxed but a fur coat that may cost much less is taxed 10 percent.

A man's hand-tailored suit costing $150 or more is not taxed, yet a tie holder costing $1 or less is taxed.

Fine porcelain figurines are produced in this country costing up to several thousand dollars each and are sold without tax while a functional bread tray plated with silver and costing but a few dollars is subject to a Federal retail excise tax of 10 percent.

A wedding ceremony may involve the expenditure of hundreds of dollars for floral decorations without special tax but the simple band of gold symbolizing the holy bond of matrimony and costing but a few dollars, is subject to excise tax.

Respect for our tax laws can only be maintained if we are constantly vigilant to root out such flagrant inequities and obvious inconsistencies. The use of taxing power to restrictively single out certain industries producing and distributing useful goods in open competition is alien to the basic precepts of our free American economy.

We submit that repeal of the Federal retail excise tax would have an immediate and continuing beneficial effect on our economy. I know of no other action that could increase sales of our products as rapidly in every city, town and village in the United States. It would increase sales and thus provide new jobs even if personal income taxes were not reduced. But, coupled with a reduction in income taxes, it would be unbeatable as a stimulant. The effect of this action would be increased buying in all consumer products. More money in the pay envelope is a self-evident fact, but by repealing the Federal retail excise tax at the same time income taxes are reduced, you enlist the support of thousands and thousands of retailers throughout the United States in reminding consumers they have it to spend.

Planning a tax program best suited to the needs of our complex economy is a job of mammoth proportions. Those charged with such responsibility must, of necessity, deal only in broad economic principles. Calculations and projections have to be based on averages. How many new jobs will be created by a tax cut of so many billion dollars spent and respent in our economy, et cetera? Where best to make this cut? It is a stupendous task and frankly, we have much sympathy for those who have it to do.

We point out, however, that because the basic intent of a tax cut is the creation of new jobs, the use of averages can be misleading in one very important area. It is correct to average manufacturing jobs by industries but incorrect to average manufacturing jobs by products. Much more labor, in relation to total unit cost, is required for the manufacture of some products than it required for the manufacture of other products. Automation has constantly reduced jobs in the manufacture of some products. Automation has not materially reduced jobs in the manufacture of the bulk of the products subject to the retail excise tax, nor can it in the forseeable future, for a very basic reason.

Automation can be applied efficiently only to those products made in very large quantities. Where it can be used the resulting product has a low labor content in relation to total unit cost because output per man-hour has been substantially increased. Thus fewer and fewer people are continually being employed for the manufacture of more and more units. Automation cannot profitably be applied to the manufacture of products made in relatively small quantities as are most items subject to the Federal retail excise tax. The tooling

and setup cost would be so high as to more than offset any savings in production cost, and, therefore, it is still more efficient to make these products without automation than with it. Because ouput per man-hour remains relatively static, such items have a high labor content in relation to total unit cost. When you manufacture more units of these products, you must employ more people.

Thus, while a million dollars of new spending on low-labor-content products will create a given number of new manufacturing jobs, the same amount spent on high-labor-content products will create twice or more as many new jobs. The products on which the bulk of retail excise taxes are collected, are high-labor-content products. Automation has not displaced people in the manufacture of these products.

Evidence of that fact is clear from the following example: One of the manufacturers who is a party to this statement makes both low-labor-content products and high-labor-content products. He is rated as highly efficient in the manufacture of both types. The low-labor-content product selected for this example is not subject to the retail excise tax. The high-labor-content products are subject to that tax.

For a given unit of sales of the low-labor-content product, this manufacturer employs one person. For this same unit of sales of high-labor-content product A, this manufacturer employs 2¼ people. For this same unit of sales of high-labor-content product B, this manufacturer employs 2¾ people.

New manufacturing job opportunities open up in this company in the same ratio: 2¼ to 2¾ jobs in high-labor-content products for every one job in low labor content—on the same dollar volume of sales.

It certainly does not make economic sense to put a brake on the sale of high-labor-content products, or in this instance to knowingly let that brake continue, when increased sales of these products will create the highest rate of new jobs per dollar spent out of the new purchasing power to be available. The retail excise tax is a brake on the sale of the products on which it applies. It was intended to be. It continues to be.

The fact that a product has a high labor content does not mean that only skilled labor is employed in its manufacture. I want to make this point very clear because of today's well-founded concern about lack of job opportunities for young untrained people as they come into the labor market. Obviously, certain operations in the manufacture of our products require cultivated skills. However, the committee should realize that by far the bulk of manufacturing operations in the industries I represent, can be performed efficiently after a reasonably short period of inplant training. Such training is available in the plants of those who are parties to this statement. In fact, it is from the ranks of the unskilled, mostly young people fresh from school, that approximately 80 percent of our work forces are recruited. You will help more and more of these young people to get jobs when you repeal the Federal retail excise tax.

In the same manner, repeal of the Federal retail excise tax will open up new job opportunities in all channels of distribution. Think of the wide variety of retailers involved—clothing stores, drugstores, jewelers, department stores, luggage stores, women's specialty shops, beauty shops, et cetera, all selling one or more products of the tax.

It is important the committee realize, too, that most of the companies engaged in the manufacture and distribution of products subject to the Federal retail excise tax are small companies. All but a few are in the Government category of "small business."

In conclusion we submit—

1. The Congress has a moral obligation to repeal the wartime-imposed "temporary" and discriminatory Federal retail excise tax now that it intends to reduce tax rates that are a part of permanent tax laws.

2. That repeal of the regressive Federal retail excise tax now will benefit the economy where it needs it the most—by the rapid and substantial creation of new jobs at one of the highest rates possible in relation to new consumer expenditures.

Therefore, we respectfully urge that the committee vote to repeal the Federal retail excise tax and amend H.R. 8363 to so provide.

The CHAIRMAN. Thank you, Mr. Paul.

Any questions?

The committee will recess until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

UNDERWOOD, NEUHAUS & Co., INC.,
Houston, Tex., November 14, 1963.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: In your consideration of the current tax bill, I would like to report the views of numerous investors in our area with whom we have contact.

They are encouraged to see the possibility of some relief in long-term capital gain tax rates, and would urge favorable consideration of any possible reduction in rates of tax and length of holding period. To the degree that such changes are made, capital will be increasingly unlocked and available for new financing necessary to create jobs for our expanding work force. At present many investors who would be interested in making new commitments feel "locked in" to present holdings by capital gains tax liabilities.

They like the proposed increase in the dividend exclusion but are at a loss to understand the proposed cut in the percentage credit since at present rates it does not provide adequate relief from double taxation. In all fairness it would seem that the income represented by dividends should be taxable to the company or the individual, but not to both. If more equity capital is to be made available to create jobs, it seems that stockholders should be treated as first-class citizens and given some encouragement.

There is a further revision of long-term capital gains taxes we would like to see considered. This would involve a change in the alternative method of computing net long-term capital gains tax. We would suggest that that part of net taxable long-term gain falling at or below the bracket used for maximum tax purposes (presently 50-percent bracket) be treated as presently, but that any excess be subjected only to the maximum rate (presently 25 percent).

Example: A single taxpayer with net taxable income from other sources of $12,000 has five separate long-term gains of $4,000 each (total $16,000). His tax rates on the four gains would be as follows:

[In percent]

	Present rates	Our proposal
1st gain	21½	21½
2d gain	23½	23½
3d gain	25	25
4th gain	26½	25
5th gain	28	25

If his net taxable income from other sources were $16,000 he would pay no more than 25 percent on any gain. The present method presents a problem for all taxpayers in a bracket below 50 percent who have capital gains carrying them into brackets higher than 50 percent.

Such taxpayers must try to spread out their capital gains in order to avoid paying a higher tax on some of them than larger taxpayers would have to pay. In extereme cases, a tax of much more than 28 percent could be paid by taxpayers with relatively small income from regular sources.

The present alternative method calls for all gains to be lumped with a test to determine whether the overall tax on all capital gains amounts to more than 25 percent, in which case the 25-percent maximum would apply to the gains as a total. Under the suggested method, no part of the capital gain would be taxed at more than 25 percent.

With best wishes.

Respectfully yours,

JOSEPH R. NEUHAUS.

DAIRYMEN'S LEAGUE, COOPERATIVE ASSOCIATION, INC.,
New York, N.Y., November 11, 1963.

Hon. HARRY F. BYRD,
Chairman of Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Your committee now has under consideration H.R. 8363, being the proposed Revenue Act of 1963, and upon the provisions of which you are currently holding hearings.

I would like to call to your attention certain related tax inequities which, although not treated in H.R. 8363, were placed before the House Ways and Means Committee, and would appropriately be subject to your review and consideration.

Hon. Douglas Dillon, in his testimony before the House Ways and Means Committee on the President's 1963 tax message, recommended consideration by that committee of a proposal which would establish an excess deductions account to accumulate farm losses of taxpayers with substantial nonfarm income and, subsequently, to treat such amounts as ordinary income upon the profitable sale of capital assets of the taxpayer.

Although this proposal was strongly supported in the testimony of Secretary of Agriculture Orville L. Freeman, the House Committee did not see fit to include it, or any provisions which would accomplish the same result, in the draft now before your committee.

This association, like many throughout the country, is a farmers' cooperative, whose 16,000 individual members are engaged in dairy farming in the northeastern area of this country. These farmers have substantial investments in their dairies and, of course, compete for markets with other dairy farmers in this area and dairy production in other areas throughout the entire country. They have become increasingly concerned over the entry into dairy farming of many individuals who derive their principal income from other sources but who, in many cases, have invested in farms primarily for the purpose of incurring tax losses which can be set off against their other income.

At the recent annual meeting of this association held in Syracuse, N.Y., on October 17, our delegate body adopted the following resolution:

"Whereas the present tax laws permit individuals not primarily engaged in farming or dependent upon their farms for their lievlihood to engage in so-called hobby or part-time farming for the purpose of accumulating tax losses; and

"Whereas this deprives the Government of tax revenues and subsidizes the production of surplus agricultural products; be it

Resolved, That the association seeek legislation or administrative regulation which will discourage the operation of farms for tax loss purposes."

This merely affirmed the established policy of the association which was reflected in our communications to the House Ways and Means Committee at the time it was considering the President's tax proposal.

Secretary Freeman, in commenting upon the nature of this activity, very appropriately stated: "These tax-motivated investments hurt farmers and legitimate farm investors. Tax-motivated investors can afford to operate a a substantial loss and yet, solely because of the structure of the present tax laws, realize a profit. Thus, present law encourages uneconomic operations and the bona fide farmer who is seeking an actual profit from his farm is at a competitive

disadvantage with such operations since he cannot afford to pay artificially high prices for land, labor, feed, animals, etc."

In addition, at a time when many are objecting to the cost of Government agricultural programs, it seems contradictory for our tax laws to encourage surplus production.

I am aware that the present tax law and regulations are intended to prevent an overextension of hobby or part-time farming, and that they are interpreted as diligently as possible to prohibit this activity. It is apparent, however, that additional regulatory procedures are needed if this practice is to be discouraged. While the proposal before the House, which is more completely set forth in the printed hearings of February 6, 7, and 8, 1963, part 1, pages 144–146, is one way to reach this objective, I am certain that it would be appropriate for your committee to consider other means to protect legitimate farm enterprise from this tax-inspired competition.

I would therefore like to ask your committee to give this problem your consideration and thereby recognize one of the current complaints of the bona fide farm family.

Would you kindly make this letter a part of your hearing record?

Very truly yours,

GLENN TALBOTT, *President.*

COUNCIL OF PROFIT SHARING INDUSTRIES,
Chicago, Ill., December 3, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The Council of Profit Sharing Industries has waived its opportunity to testify before your committee on December 3, 1963, concerning the taxation of lump-sum distributions from qualified profit-sharing plans. The council wishes to conserve the committee's time inasmuch as H.R. 8363, in its present form, would not change the present method of taxing such distributions, and inasmuch as the Treasury Department has not renewed its request, nor has any member of your committee formally proposed that such distributions be taxed as ordinary income. However, in order that the council's position may be made known to the committee, it is respectfully requested that the following statement be incorporated as a part of the record of the hearings before the committee on H.R. 8363:

The Council of Profit Sharing Industries is a nonprofit association of approximately 1,000 companies. These companies have profit-sharing plans covering in excess of 1 million employees in all types of business throughout the United States. The council submits this statement for two basic reasons. First, we have noted that some members of this committee have expressed concern from time to time with respect to the present tax treatment of lump-sum distributions. By this statement the council hopes to set such concern at rest and to show how the present tax treatment of such distributions is consistent with the purposes of H.R. 8363. Second, the council would like the committee to know that it endorses, without qualification, the provisions of H.R. 8363 relating to the taxation of such lump-sum distributions.

HOW H.R. 8363 WOULD TAX LUMP-SUM DISTRIBUTIONS

The bill before the Senate Finance Committee would divide long-term capital gains into two classes—class A capital gains and class B capital gains. Class A capital gains would be taxed more favorably than capital gains are taxed under present law. Class B capital gains would be taxed in exactly the same manner as long-term capital gains are now taxed. Lump-sum distributions from qualified profit-sharing plans, which have long been taxed as capital gains, would be classified as class B capital gains. Thus, at the time these distributions are made, they would not be granted the more favorable treatment contemplated for class A capital gains, and the council does not request such treatment. Of course, where an employee's interest in a qualified plan is distributed to him in property, any gain on such property accruing after the distribution should be taxed as class A gain if the holding period requirements are met, and H.R. 8363 so provides.

THE PURPOSES OF H.R. 8363

The council agrees with many of the premises which gave birth to H.R. 8363. Thus, the council agrees with the administration that the present tax structure is a heavy drag on private purchasing power, initiative, and incentive. Further, the council shares the views expressed in the report of the Ways and Means Committee that—

"Today it is essential that the rate structure not inhibit initiative on the part of individuals, either as employees or as managers or owners of business. It is especially important that the youth of the country have both the opportunity and the incentive to devote their full talents, abilities, and energy in the building of a strong society."

WHAT IS PROFIT SHARING?

The sharing of the fruits of capital and labor is as old as mankind. The council, through its activities, seeks to promote and expand this desirable goal. In the council's view, profit sharing is not merely a substitute for current salaries or wages. It is, rather, a very significant supplement to the regular salaries and wages currently paid for services rendered. Its basic aim is to develop a sense and a fact of partnership between the employer and his employees so that they will have the common goal of making the buiness profitable. It is axiomatic that, by being entitled to share in profits, employees are enabled to share more directly in the growth and prosperity of the company.

The council feels that profit sharing encourages economic growth and thereby makes an essential contribution to a sound economy. It is the firm conviction of the council that profit sharing has resulted in increased revenues for the Government, increased productivity among employees, better management-employee relations, increased jobs, a greater stability of employment, and increased security for employees with whom profits are shared.

It is clear that profit sharing was not established with any Federal income tax statute in mind, since the movement antedates the income tax system. For instance, in the United States the oldest profit-sharing plan still in existence was established by Procter & Gamble Co. in 1887. Many other well-known existing plans were established decades ago. It is noteworthy that many of these plans were established when the persons establishing them had no idea of how they were going to be treated under any tax system. It is not at all surprising, in view of the many nontax advantages that flow from profit-sharing plans, both to employers and employees, that the profit-sharing movement as we know it today began so many years ago and that the profit-sharing principle is embraced today by more than 35,000 employers.

In 1942, Congress, aware of the increasing growth and expansion of the profit-sharing principle and the important contribution which it could make, established the present provisions of the code covering the tax treatment of profit-sharing plans. In 1951 and 1952, Congress reviewed and reaffirmed this treatment when it provided for the deferral of tax on unrealized appreciation in securities of the employer corporation received at the time of distribution. In 1954, Congress undertook a comprehensive revision of the Internal Revenue laws and again reaffirmed the provisions on the tax treatment of profit-sharing plans. The council feels that such tax treatment has encouraged the growth of profit sharing, and that it would be unwise to enact legislation which creates an unfavorable climate for the continued growth of the profit-sharing movement. By long-established congressional policy, profit sharing has been considered in the national interest. We are pleased that H.R. 8363 would make no change in this long-established judgment of Congress.

Profit sharing has grown under the fair tax treatment consistently reaffirmed for over the past 20 years and there is no justification for significant change under the guise of reform or revenue requirements.

THE EMPLOYEE'S PROFIT-SHARING ACCOUNT IS A CAPITAL ASSET

As soon as a contribution is made to a profit-sharing plan it becomes the property of the participating employees. It is true that the employee's interest in the account does not always vest immediately, but this does not change the fact that he has a beneficial interest in the assets of the plan. Whatever happens to those assets directly affects the interests of the employee. He is the "risk taker." An appreciation in the value of such assets, in the value of any assets acquired with employee contributions, and the value of assets acquired through

reinvestment of earnings, is capital appreciation on property beneficially owned by the employees who are participants in the plan. Conversely, any depreciation in the value of those assets and any losses incurred in the investment of those assets is incurred by the employees. The employee's interest in the plan is very much like his interest in independently purchased stocks, his home, or any other assets which he himself has purchased. His profit-sharing interest therefore should be considered a part of his capital assets.

It is unsound to argue, as some do, that a company's contribution to a profit-sharing plan is merely the first stage of a continuing transaction involving payment of compensation to the employees, and that the character of the contributions as compensation, together with all appreciation and earnings, does not change during the period of accumulation.

The council maintains that an employee's profit-sharing account is a capital asset. Such an account is made up of assets from several sources. These sources are: (1) Initial employer and employee contributions; (2) capital appreciation on assets purchased with these contributions; (3) reinvested earnings in the form of dividends, interest, etc.; and (4) capital appreciation on reinvestment of earnings.

It would be unsound in principle, as well as unfair, to tax as ordinary income the capital appreciation on assets purchased with employer or employee contributions, or the capital appreciation on reinvestment of earnings. Clearly the income from these sources is capital gain under the traditional definition of capital gain for Federal income tax purposes.

It has been argued that other elements contained in a lump-sum distribution (employer contributions and earnings in the form of dividends, interest, etc.) are not properly classed as capital gains. It would be inequitable, however, to tax as ordinary income the portion of a lump-sum distribution attributable to employer contributions and earnings. In many instances the tax on a lump-sum distribution under the graduated rate structure would be virtually confiscatory. The lump-sum distribution often will represent amounts accumulated over as many as 35 or 40 working years. Clearly it would be inequitable to tax such lump sums under the graduated rate structure even with limited relief provided by some form of averaging. Many employees would be required to pay more tax than they would have paid on their gains if they had been taxed each year as the funds accumulated.

The capital-gains tax provides a fair and equitable method for taxing lump-sum distributions from a profit-sharing account, even if some part of the account is viewed as a form of bunched compensation. The capital-gain method is readily understood, easy to administer, equitable, and imposes a fair tax on the employee. Other methods which have been suggested are complicated, impractical, and generally unfair.

THE NEED FOR CHANGE HAS NOT BEEN SHOWN AND NO REVENUE RECOUPMENT IS INVOLVED

The bill before you was conceived and presented with two major objectives in mind:

(1) Tax reduction; and
(2) Tax reform.

A stated purpose of the tax reform portions of the bill is to recoup some of the revenues which it is anticipated will be lost through the tax reduction provisions of the bill.

Therefore, the question of whether or not reform is needed in this area is perhaps still to be clarified. In attempting so to do, it is the council's view that the two underlying broad questions must be answered: First, is the present tax treatment of lump-sum distributions an "abuse" which requires reform; and, second, if it is not an abuse, is so much revenue being lost through the present method of taxation that a change is needed for revenue-producing purposes?

In the spring of 1960, when the Senate Finance Committee was considering H.R. 10, it was suggested by the Treasury Department in its alternative to H.R. 10 that, along with many other momentous changes in the provisions of the Internal Revenue Code affecting profit sharing plans, the long-term capital gains treatment of lump sum distributions should be repealed. At that time, in the absence of any hearings on the proposal, or any evidence to support it, this committee rightfully rejected this proposal of the Treasury Department.

Early this year, the Treasury Department made public its supporting data for a similar proposal before the Committee on Ways and Means. The committee's attention is respectfully directed to exhibit 17 of part I of the hearings before the House Ways and Means Committee in February of this year. It should be noted that the executive department best equipped with statistics of income and income distribution and the taxes payable thereon, and with the greatest resources for assembling information pertinent to the situation, is the Department of the Treasury. Exhibit 17 shows that the Treasury Department could offer only 23 individual cases under 4 qualified pension and profit-sharing plans that allegedly constituted abuses in the area in question. These alleged abuses were gleaned from a survey which apparently covered an 8-year period. On the other hand, witnesses opposed to the Treasury Department's proposals before the House Ways and Means Committee (including the council) furnished evidence covering thousands of distributions which were made over a much shorter period of time and showing that the vast majority of the distributions made, as well as the amounts distributed, went to persons of average means. The council suggests that the Treasury Department's evidence is a very limited showing of alleged abuses in view of the thousands of lump sum distributions made from the many plans with respect to which information was accessible to the Treasury Department.

Significant as the fact is that only 23 individual cases from four plans were presented, it is more noteworthy that the Treasury Department failed to give additional important information necessary to analyze these cases. For example, no indication was given whether the amounts in question were accumulated over a few years, or over periods of 30 or 40 years. It was not made clear whether parts of the distributions consisted of the employees' own contributions and the earnings and appreciation thereon. Moreover, no indication was given as to what part of the amounts cited consisted of employer contributions as compared with appreciation in the value of investments once those employer contributions became the property of the employees. Finally, exhibit 17 did not show whether the distributions cited were made to low-, middle-, or high-bracket taxpayers.

Based on the evidence given to the Ways and Means Committee, the council believes that the committee properly rejected the proposal advanced by the Treasury Department. It is submitted that the record to date shows that the Treasury Department has failed to prove is case that the present tax treatment of lump-sum distributions is an abuse.

Aside from the question of abuse, this committee may wish to consider whether any change in the present method of taxing lump-sum distributions is desirable to recoup some of the revenue losses arising from the tax-cutting provisions of H.R. 8363. The Treasury Department's proposal before the Ways and Means Committee regarding lump-sum distributions from qualified profit-sharing plans was classified under the general heading of "definitional changes." Lumped together with other definitional changes, the Treasury Department estimated net revenue recoupment of $8 million a year when certain of the definitional changes (i.e., those relating to lump-sum distributions, patent royalties, or stock options) became fully effective. In the context of a $100 billion annual Federal budget, and lacking more reliable evidence that an abuse is involved, a proposal which would recoup a fractional part of $8 million annually can hardly be pressed on the ground that it provides substantial revenue recoupment.

In summary, the record available demonstrates that—

(*a*) No abuse has been shown; and

(*b*) A change in the method of taxation of lump-sum distributions along the lines proposed at various times in the past 3 years would recoup practically none of the revenue which will be lost through the tax-cutting provisions.

In view of these conclusions, the council respectfully urges the committee to concur in the decision reached by the Committee on Ways and Means and the House of Representatives and to adopt no changes in the present method of taxation of lump-sum distributions from qualified profit-sharing plans.

Very truly yours,

S. D. NOBLE, *President.*

IOWA TAXPAYERS ASSOCIATION,
Des Moines, Iowa, November 1, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: As representative of a statewide citizens organization that wants to see sound fiscal policies at the Federal level, I want to express for the committee record our views on H.R. 8363.

It appears that the bill as passed by the House is deficient in two serious respects:

First, it is deficient in that the proposed adjustments in rates do not actually accomplish what the President had advocated; namely, a substantial reduction in the very steeply graduated upper- and middle-income rate brackets to remove the present deterrent effect of the steeply progressive rates on incentive and capital accumulation and to make the rate structure more equitable. This later point is very important because the only justification for the steeply progressive rates that is given by those who defend the existing rate structure is based on their belief that income is not fairly received and distributed among the people. If it is equitably received and distributed, as we believe it is, then there is no reason why the middle- and upper-income bracket people should bear such steeply progressive rates.

The second reason that the House bill is unsound, is that there is no real provision in it to control expenditures in order to assure that tax reductions will not create permanent deficits.

Under the Herlong-Baker proposal, which we subscribe to, a substantial part of the tax reduction would be deferred until such time as there was an assurance that increased revenues would offset the decreased taxes resulting from the rate reductions. This would be accomplished by permitting the natural growth in revenue to be used to accomplish tax reduction rather than to be put into new spending projects.

Inasmuch as the bill passed by the House only gives lipservice to true rate reform and contains no control device for limiting future spending to avoid deficits, we respectfully ask that your committee recommend the adoption of a tax rate reform bill containing the provisions in the Herlong-Baker proposals in lieu of recommending for passage the tax bill you received from the House.

If the complete rate reform proposal of Herlong-Baker is not considered attainable at this time, we would strongly urge as a substitute the rate reform proposal submitted by Mr. W.P. Gullander, president of the National Association of Manufacturers, in his October 29, 1963, presentation to your committee.

Respectfully yours,

WALTER R. COCHRAN, *President.*

STATEMENT BY HENRY J. CLAY

Mr. Chairman and members of the committee, my name is Henry J. Clay. I am a member of the law firm of DeWitt, Lockman & DeWitt, 120 Broadway, New York, N.Y., counsel to the Realty Committee on Taxation. This committee is composed of representatives of the building construction industry, the financial community, and others with special interest in the purchase and development of real estate principally located in the city of New York. I am most appreciative of this opportunity to express the views of our committee on certain aspects of H.R. 8363 which is presently before your committee for study and consideration.

The realty committee on taxation has appeared as a public witness before the House Committee on Ways and Means in connection with H.R. 8363 and has filed several statements, tax memorandums and supporting data relative to its interest in that phase of the proposed tax bill which concerns the recommendation to tax as ordinary income certain gains on the sale or other disposition of improved real property. There are many technical aspects concerning this proposal with which we are concerned. In order to conserve the committee's time, I respectfully ask permission to file with the staff a memorandum which will outline our views and recommendations on certain corrections which, in our opinion, are fair, reasonable, and equitable, and we ask your consideration of these several points when this matter before you goes into executive session.

Our committee was opposed to the President's recommendation, as supplemented by the Treasury Department's observations and comments. It was felt by us that the original proposal was a radial change in this vast field so vital to our economy and that if these recommendations were enacted into law, they would have a serious depressing effect on the construction of industrial and commercial buildings. After numerous conferences with members of the House Ways and Means Committee, staff personnel of the committee, and representatives of the Treasury Department, our committee found that it was able to accept the bill as reported out by the House committee with only objection to several technical defects which we believe can be worked out with the staff of your commitee toward the end that a suitable and workable provision can be written which will curb the abuses complained of by the Treasury Department while preserving certain necessary incentives essential to growth in the real estate industry. Toward this end, our committee accepts that portion of H.R. 8363 which provides for a revision of the tax treatment occasioned on the sale or other disposition of depreciable real property, subject, however, to certain technical changes in the wording of the proposed statute.

(Whereupon, at 12:50 p.m., the committee was in recess, to reconvene at 10 a.m., Wednesday, December 4, 1963.)

REVENUE ACT OF 1963

WEDNESDAY, DECEMBER 4, 1963

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 (chairman) presiding.

Present: Senators Byrd, Douglas, Gore, Ribicoff, Williams, Bennett, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

We are honored today to have the distinguished Senator from Alaska, Senator Gruening.

Will you please proceed, sir.

STATEMENT OF HON. ERNEST GRUENING, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator GRUENING. Mr. Chairman, thank you very much for giving me this opportunity to appear before this committee in behalf of my amendment, No. 204, to H.R. 8363, the bill before you to amend the Internal Revenue Code of 1954.

On June 27 I introduced the measure about which I wish to testify as S. 1807, which was cosponsored by Senators Allott, Bartlett, Bible, Engle, Humphrey, Long of Missouri, McGovern, Moss, Mundt, and Simpson.

Following this I was wisely advised by my good friend the distinguished chairman of this committee, that the proper form for consideration of the matter would be as an amendment to H.R. 8363 after passage of the bill by the House of Representatives. Accordingly, my proposal is now before you as amendment No. 204 to H.R. 8363.

The purpose of the amendment is very simple. It is to allow all exploration expenditures, whenever incurred by a taxpayer in connection with mining operations, to be currently deducted. Enactment of the amendment would remove the limitation on deduction of exploration expenses now in the law under which these deductions are limited to a total of $400,000, and, in any one year, to a total of $100,000.

The amendment specifically excludes application to exploration for deposits of oil or gas.

On May 9 and 10 of this year I conducted, as chairman of the Subcommittee on Minerals, Materials, and Fuels of the Senate Interior and Insular Affairs Committee, comprehensive hearings on the state of the American mining industry. Testimony was presented by all

executive agencies of the Government concerned and by many segments of the mining industry describing the current problems and prospects for this important segment of the domestic economy.

The broad picture that emerged was, with some exceptions, that of an industry that should be a vital force in the domestic economy, yet hindered and depressed by a variety of Government-imposed policies and by exceedingly difficult problems arising mainly from constantly rising operating costs, unstable markets, and general industrial insecurity.

While two industries, gold mining and lead and zinc mining, may be singled out as particularly depressed, in the case of gold, the word "depressed" is inadequate; it should be "moribund." A general review of the status of mining by the Assistant Secretary of the Interior for Mineral Resources, the Honorable John M. Kelly, elicited the following comment:

> Income generated by mining industries remained behind the national upward trend. Metal mining income continued to decline significantly, whereas nonmetal mining income made modest gains. Employment declined through the year, reaching a new low at year's end.

The restriction now imposed by the Internal Revenue Code on deductions for expenditures for essential exploration quotations was generally cited as a particularly irksome and unjustified discrimination against an important industry. Enactment of my amendment will eliminate this limitation, improving Federal Government policies now hampering mining progress and, consequently, improve the economic condition of the mining industry.

As noted above, our review of the state of the domestic mining industry revealed two segments of the industry in a particularly unhappy condition.

The gold mining industry is uniquely hampered and distressed by actions of the Federal Government. It will be impossible for this industry to survive at all unless legislative relief is supplied that will reverse the repressive effects of an arbitrary price of $35 an ounce established 29 years ago, and compensate for the enforced destruction of the industry during World War II by War Production Board Order L-208.

As the sad condition of the gold mining industry is directly caused by action of the Federal Government, and the Treasury Department is its only customer, I believe it has the strongest case of any mining industry for relief. Here we have an industry that, by government fiat, cannot increase its price for its product despite the constant increase in all its costs of production and operation. Forced, alone of all gold mines in the world—in a nation that proudly proclaims its free enterprise system—to cease production during World War II, American gold miners cannot afford the expense of reopening mines long closed and now inoperable. No business can survive, let alone prosper, in this condition.

But not only because of the reasons for its plight, but because our economy cannot afford to have any segment of it depressed where a remedy is easily available, the gold mining industry must be revived. In 1962, the production of gold in the United States reached its lowest level except for World War II years, only approximately 1.5 million ounces—contrasting with domestic consumption for industrial and

commercial purposes of nearly 3.6 million ounces, and even more sharply with the nearly 5 million ounces produced in our peak production year of 1940. This was reflected by a reduction in numbers of mines operating from 9,569 to 660 and a decrease in employment of 56,200 to 4,300 persons.

In my judgment, the role of gold as the standard of international monetary exchange has been exalted to such a degree it has paralyzed, if not the search for legislative solutions to the plight of the gold mining industry, which search has been pursued with vigor in the legislative branch of our Government, but whose success has run aground on the rocks of Treasury Department opposition.

While no one interested in gold has any wish to upset the financial stability of the world, we feel that the Treasury Department, supinely followed by the Department of the Interior has, for too long, refused to encourage aid to an important industry on the ground that in some mystic way the international banks would fall into a panic at the very idea.

I believe there are ways of reviving the gold mining industry that can be entirely separated from the function of gold as a medium of finance and I continue to hope the executive branch of the Government which has failed to produce any constructive alternatives despite repeated requests will also come to this view and help, rather than hinder, legislative efforts to solve the problems of gold miners.

In the case of lead and zinc, which is also a depressed mineral industry, the problem focuses on trade policies dictated by the Department of State which allow foreign producers to fill our domestic markets' demand, leaving domestic producers without customers they would otherwise have.

In his testimony at the May 9 and 10 hearings Assistant Secretary Kelly referred to the continuing importance of exploration for new sources of minerals and emphasized the rapidity of advances in exploration techniques. The following quotation from Secretary Kelly's testimony demonstrates the complexity and cost of exploration methods used today and the effect that this has in increasing the sums required to be paid by mining enterprises for this phase of the process of bringing the mineral wealth of the Nation to usable form.

> Our future technology is dependent upon the vigor with which we find and appraise new sources of ores and minerals and devise more effective methods for handling and processing ores and waste * * *.
>
> The technology of finding, extracting, and processing minerals has greatly changed during the past 30 years. Indeed, the changes have been almost revolutionary. Most mineral deposits that have eluded surface search by the prospector, using conventional methods of ore finding, probably repose beneath soil, valley fill, or barren rock at depths where detection requires the application of scientific techniques and special instrumentation.
>
> Also, the list of minerals for which we search is no longer confined only to the precious and the base metals. The oldtime prospector is vanishing, being replaced by trained fieldmen equipped with the techniques of geophysics and geochemistry, and utilizing new methods of geological analysis. His burro is replaced by the jeep, the airplane, or the helicopter.

It is clear that modern methods of minerals exploration are highly complex in application and of enormous importance to the successful establishment of a mining business. The mining industries consider the expense of this vital part of their operations should be fully deductible on the same basis as are research expenditures of other busi-

ness enterprises. I believe there is strong justification for this. Webster's dictionary defines research as "careful or diligent search, a close searching; as 'researches' after hidden treasure." Certainly, this is an exact description of the act of exploration for minerals—hidden treasures.

Clearly, expenditures on exploration for minerals should be fully deductible to mining industries. There has been gradual recognition of this, as the present law demonstrates.

Before passage of the Revenue Act of 1951 all exploration expenses were required to be capitalized, and this is still true with respect to those expenses which exceed a total of $400,000 at a rate of $100,000 a year. The 1951 Revenue Act allowed a limited deduction of $75,000 a year for exploration expenses for each year of any 4-year period selected by the taxpayer—permitting a total deduction of $300,000 over a 4-year period. The trap in this provision was that, should the unwary taxpayer deduct even a limited amount—for example, $1,000—in any year, 1 of his 4 years was thereby used, and his total allowable deduction immediately dropped by the difference between the deduction and the total annual allowable deduction of $75,000.

The 1954 amendments to the Internal Revenue Code changed this provision again. This time the total deduction was increased to $400,000 and a per annum total of $100,000 provided. Finally, in 1960, Public Law 86-594 removed the 4-year limitation on deductions for exploration expenses, allowing deductions to be taken at any time, but retaining the $400,000 and $100,000 per annum total deductions allowable.

Thus, the principle that exploration expenditures are necessary costs of the mining business and should be deductible as are other costs of operation has been recognized. The amendment before you now would extend this principle to its logical conclusion and remove all limitations on deductions of these expenditures.

The mining industry of the United States is a very important part of our economy. For an industrial base for defense, for supplying all the myriad needs of human beings, we must continue to produce the raw materials. This will not happen unless the mining industry is healthy, stable, and profitable. I urge the adoption of this amendment as one means of giving aid needed to make this the case.

Thank you again for giving me this opportunity to testify.

The CHAIRMAN. Thank you very much, Senator. I know you are a great student of this question.

Senator GRUENING. Thank you very much, Mr. Chairman and members of the committee.

Senator GORE. Mr. Chairman, I would like to ask the Senator a question, if I might.

You made an interesting, provocative statement on the floor of the Senate a few days ago on the need for tax reform.

I wonder if you were as shocked as many of us were when Senator Douglas brought to light statistics which he secured from the Department of the Treasury showing a number of people with million-dollar-per-year incomes, and some with multimillion-dollar-per-year incomes who paid no taxes at all and were not required to pay any at all by present law.

Senator GRUENING. Well, yes. I thought—I might put it this way. I think this was something for Ripley, unthinkable, that a man with an income of $5 million, or $1 million, or $2 million, or $3 million should pay no income tax, and I would hope that any tax measure passed by this Congress would remedy that and make that impossible in the future.

I remember how 30 years or more ago in the time of the depression we were all very much shocked to learn that the members of the House of Morgan had paid no tax in the previous year. They had found methods of taking offsets and deductions so, although their incomes were very large, the loopholes existing at that time in the tax legislation allowed them to pay no taxes, and I believe that was remedied thereafter or sought to be remedied, but apparently there are still very glaring loopholes, and I would hope as a Member of the Senate that when the bill comes before us, some of these loopholes will be plugged.

It is hardly fair to expect the great run of Americans who pay their taxes conscientiously to do so and yet be aware of the fact that others whose incomes are many, many times larger are escaping completely untaxed and unscathed.

Senator GORE. I wish to call to your attention a table which I have found most interesting which I shall later show you on page 709 of the hearings before this committee. This table was furnished to the committee by the Treasury Department at my request. I must say I was very surprised at its contents. I have heard a good deal about confiscatory taxes, about how people were facing almost a capital levy, and that so many people were paying in the 91-percent bracket, to whom we just must give relief.

I asked the Treasury to supply statistics with respect to typical taxpayers in various income groups ranging from $3,000 per year to $1 million per year. The typical taxpayer, I was advised, is a man with a wife and $1\frac{7}{10}$ children. The nearest they could come to a typical taxpayer was a man with a wife and two children.

Well, this typical sort of composite taxpayer, so to speak, is shown in the various income groups with an adjusted gross income of $3,000, $4,000, $5,000, $6,000. You find that on page 709, do you?

Senator GRUENING. Yes; I do.

Senator GORE. Now, I am sure you will be quite surprised when you see that the tax that this typical taxpayer now pays is listed in the second column and you will find that the man, not a millionaire one time, but a man who has $1 million per year adjusted gross income—you understand his actual income may be much larger than that because there are several types of income which are not includible in the term "adjusted gross income." But here is adjusted gross income of $1 million per year. Instead of this taxpayer paying in the 91-percent bracket, you will notice he is paying in the 26-percent bracket.

Does that come as a surprise to you?

Senator GRUENING. Yes, it does.

Senator GORE. If you will notice, this typical taxpayer with $100,000 per year income pays a higher percentage of his income in taxes than the man with the $1 million per year income, but even he only pays 33 percent. How would you explain that?

Senator GRUENING. I would find it difficult to explain. I would say that some of the startling anomalies were discussed in a recent Saturday Evening Post article by Stewart Alsop which is to the effect that nobody paid 91 percent, and this was just one of the illusions around the country, that no one paid that amount, and that there are other illusions about the heavy burden of taxation which this article indicated virtually didn't exist. People were not taxed heavily because of the many ways in which they could evade taxation or avoid taxation through existing loopholes and a wise tax accountant.

Senator GORE. Well, the political immorality of the pending bill, if I may use a severe term thus to describe it, is found in the fact that as inequitable as the present situation is, if the Senator will look at column 6, he will find that the pending bill makes it worse. The man with a $1 million per year adjusted gross income upon enactment of the pending bill, according to the U.S. Treasury Department, will pay in the 23-percent bracket. Does the Senator—I am sure the Senator realizes that many people of quite modest income pay an even higher percentage.

Senator GRUENING. Well, I should think—my reaction to that would be that that is a situation that calls for correction.

Senator GORE. But instead of——

Senator GRUENING. I am not a member of the committee.

Senator GORE. But instead of correcting it, this bill makes it worse.

Senator DOUGLAS. Well, may I interject?

Senator GORE. Yes.

Senator DOUGLAS. I think this is caused by the change in the capital gains provisions which diminished the capital gains tax to only 40 percent of the ordinary income tax subject to a maximum of 21 percent. This is the main feature and I think in justice to the Kennedy administration it should be said this provision was compensated for in the original bill by the requirement of payment of capital gains upon death.

As we all know, what the House did was to eliminate the provision requiring payment of capital gains tax upon death but to retain the reduction in the capital gains tax. So that I think this really should be charged to the House Ways and Means Committee and not to the national administration or to the Treasury.

Senator GORE. Well, I am not attempting to indict anyone.

Senator DOUGLAS. I understand.

Senator GORE. I am calling attention to the terms of the bill before the committee, and yet every time I attempt to call attention to the highly inequiable provisions of the pending bill, which creates more inequities rather than removing them, many editorials appear saying that the Senate is obstructionist. Well, if a Senator can prevent the passage of a bill which makes a highly inequitable situation much worse, it seems to me he may be serving the public interest well.

Senator GRUENING. He may be constructive rather than obstructive.

Senator DOUGLAS. May I say I think the Senator from Tennessee is well advised to make these criticisms. I hope that we can eliminate this reduction in the capital gains tax either by reinstituting the original proposal of the administration or by at least keeping the capital gains tax in its present form, even though I think it is now inadequate.

Senator GORE. Well, I shall join with my distinguished and able colleague from Illinois in trying to improve the pending bill. The chance of doing so, however, is blunted by the fact that the Secretary of the Treasury supports the bill and according to the press had some sort of an understanding with Members of the other body that he would support the bill as is. So despite these imperfections and inequities, which are glaring, our chance of removing them seems to be limited.

I would like to call to the attention of the Senator one additional thing. When Mr. Henry Ford appeared, he used a term which every workingman understands, "take home pay." I was pleased when Mr. Ford used that term. I had been trying to focus upon the percentage increase, the amount of increase in take home pay, which this bill would provide to people in various groups and the Treasury had been avoiding that as if it had been a dog with hydrophobia.

Mr. Ford accommodated this committee by urging it to pass the bill in order to give the mass of our people an increase in take home pay.

I wonder if the Senator realizes that a person with a taxable income of $6,000 per year would receive a 5-percent increase in take home pay as his benefit from this bill.

Senator GRUENING. That would not be very large, would it?

Senator GORE. It might be entirely wiped out by other things which are taken from him by the bill, such as denying him the privilege hereafter of deducting the State gasoline tax he pays for using his automobile to go to work, to take his family to church, to the park, or for whatever reason. There are a number of deductions available to the workingman under present law which would be denied to him by the pending bill.

Did the Senator realize that?

Senator GRUENING. Yes, I do.

Senator GORE. I calculated the approximate amount of tax deductions which one of my neighbors in Tennessee would be denied by the pending bill. The best estimate I could make was that he would be denied a deduction of $240 a year which is available to him under present law.

Now, this neighbor of mine earns less than $6,000 a year. He is more nearly in the $4,000 per year taxable income class. Now, he wouldn't get an increase of 5 percent in his take home pay. He would get an increase of 4.7 percent. But when you calculate what is taken away from him by the pending bill, he might wind up paying more taxes instead of less. And yet Secretary Dillon, sitting where you are sitting, told us in response to my questions of an actual example of a taxpayer who, according to the Treasury statistics, would receive an 85-percent increase in take home pay, an 85-percent increase of a very large amount. This again illustrates the inequities of this bill.

Now, would you think it fair to give a small percentage increase, a 5-percent increase in a small take-home pay to one man and by the same bill give a large percentage increase, 85 percent, to a man who has a very large take-home pay?

Senator GRUENING. Well, that would seem to justify the allegations which I have heard concerning the present draft of the bill, that it is

essentially a bill to make the rich richer, and the facts which the distinguished Senator from Tennessee cites would seem to justify that allegation.

Senator GORE. Well, Mr. Chairman, I don't want to keep my friend too long. I know he has committee meetings to attend himself. But I am undertaking, one by one, as I can contact my distinguished colleagues in the U.S. Senate to call to their attention that this is a highly inequitable, unfair, and in my opinion, unsound and unjustified bill.

Now, you say my efforts may be regarded as constructive by some.

Senator GRUENING. I would say constructive. I hope they succeed.

Senator GORE. Well, you encourage me. You encourage me.

Senator BENNETT. Mr. Chairman, may I——

The CHAIRMAN. Senator Bennett?

Senator BENNETT. Senator Gruening, I have heard this development that you have listened to many times since these hearings began and it is interesting to me that my colleagues assume that the opportunity a man with an income of a million dollars has to reduce his taxes to $261,000 arises out of the tax on capital gains.

Now, let us stop and look at this. We now have an effective tax of 25 percent on capital gains. The millionaire, they say, the man with the million-dollar income, pays $261,000 in taxes, which is 26 percent. Now, in order to get a capital gain, translate all of his income to capital gains and thus reduce the tax, he has got to sell what he owns. He can't get it out of income on what he owns. So in order to get a taxable income of a million dollars, he has got to sell $4 or $5 million worth of his assets, and you and I know that that isn't what happens.

It is my impression that one so-called loophole which makes it possible for a man with a million-dollar income to pay a low net tax rate is his investment in tax-free State and municipal bonds. Would you like this committee to pass a bill which taxes the bonds of the State of Alaska and makes it impossible for a rich investor to invest his money in the bonds of the State of Alaska and the school boards in Alaska and municipalities? If you do that, you would see this tax rate on the million-dollar income go way up because that is the loophole which makes it possible. I am sure these men make some capital gains but they couldn't depend entirely on capital gains because they would soon sell themselves out of all of their investments.

Senator GORE. Will the Senator yield?

Senator BENNETT. May I finish? You wouldn't recommend to this committee that we impose Federal income taxes on State and local bonds, would you?

Senator GRUENING. Yes, I would.

Senator BENNETT. You would?

Senator GRUENING. Yes, I would. All income should be subject to income tax legislation and be mitigated by exemptions.

Senator GORE. Mr. Chairman, may I point out, if the Senator will yield just a second, may I point out that income from tax-exempt municipal and State bonds is not includible in the term "adjusted gross income" nor is one-half of capital gains. So——

Senator BENNETT. I was speaking of total income. If we are speaking of "adjusted gross income" rather than total income, then you and I are both a little out of place in arguing that——

Senator GORE. I didn't argue that at all.

Senator BENNETT (continuing). That this is the reason why the millionaire's tax is down so low.

Senator GORE. I didn't argue that at all. I didn't even mention capital gains.

Senator DOUGLAS. Well, may I say that one reason why the reduction under the bill that comes from the House is as great as it is for those in the upper incomes is not merely because of the reduction in the individual income tax which was proposed by the administration but also because of the reduction in the capital gains tax which came to us in the House bill.

Now, let me comment on the situation of the people with incomes of over $5 million who pay no taxes. The Senator from Tennessee is quite right. These are adjusted gross incomes, and do not include, therefore, drilling or developmental costs, nor interest on State and local bonds, nor half of capital gains. They can have an actual income in excess of $5 million upon which they do not pay income tax. I have been going into the reason for this, and it is partly capital gains and partly the depletion allowance. But also, so far as I can find, this is in large part permitted by the provision of unlimited credit for charitable deductions. We have created a situation now where a wealthy man can set up a foundation, get unlimited credit for donation, but still retain control of the secuirties through the trustees. And there is one illustration which the Treasury very courageously and very properly put into its original statement of the person who took assets originally costing less than half a million dollars with a current value of over $21 million, gave them to some charitable group, and got credit——

Senator GORE. So-called.

Senator DOUGLAS. A so-called charitable group—and got a credit for $21 million.

Now, I know that presidents of universities, and so forth, want the unlimited charitable deduction and undoubtedly this does stimulate private giving, but it seems to me that people also owe an obligation to the Government as well as an ethical obligation to support private charities. When the latter is used as a complete substitute for the former, something is awry.

Senator BENNETT. But in order to get the unlimited credit right, the taxpayer has to spend 90 percent of his income either for taxes or charitable donations, for 8 or 9 consecutive years.

Senator DOUGLAS. Well, I am talking about——

Senator BENNETT. It is not a thing that is available to the ordinary taxpayer.

Senator DOUGLAS. It is available to some and I simply want to point out that, I believe, there were 10 people in the country with adjusted gross incomes—mind you, that is a very limited definition of income—of over $5 million a year who didn't pay a single cent in taxes. I do say that that is a warning signal of things that are wrong in the tax structure and that we cannot and should not close our eyes to them.

Senator BENNETT. I have not further questions.

The CHAIRMAN. Any further questions?

Senator GORE. Yes.

Upon reference to the record, I find I made a slight error. I recollected that Secretary Dillon had cited an instance of a taxpayer whose take-home pay would be increased 85 percent by the bill. I am sorry for the error. The record shows he said only 84. But mind you, that is 84 percent increase of a very large amount of after-tax income. How it can come about that a Congress supposedly representing the people and seeking equity and fairness in tax law can proceed to make the situation worse instead of better when our situation is already intolerable is beyond my conception. I cannot understand how men of good will and conscience and judgment can reach such conclusions.

Understand, they have a right to do so and they have a right to be able to lack the ability to understand my process of reason and action and I certainly say these things in view of the right of men to differ with me and me with them.

I wanted to call some of these things to the attention of the Senator and I would like also to call to his attention, since he is here and I have the opportunity to do so, that profits of corporations are at an alltime high. Dividend distribution, percentage of profits being distributed in dividends, is at an alltime high. Cash reserves are at an alltime high. The cash position, cash flow, liquidity of corporations, are the most advantageous which ever prevailed. We have a surplus of productive capacity, a surplus of investment capital, a shortage of consumer demand.

Now, under those circumstances if we must stimulate the economy, would it appear to the Senator that this stimulation should be centered upon consumer demand or upon more investment capital to add to the surplus we already have, maybe to be invested in more productive plant, when our problem is not lack of productive capacity but idle productive capacity?

Senator GRUENING. Well, I would say that I personally question the need of this tax cut at this time. It seems to me that there are more important ways in which we can stimulate our economy. I would like to see a vast increase in public works. I think our outstanding domestic problem is unemployment, and while public works would not solve it, it would certainly help solve it.

I find it difficult to follow the reasoning that this tax cut would bring in more revenues to the Treasury. I think it is going to bring less, and we are then going to be asked to curtail all public spending which I think will be very unfortunate.

I think we should have more public spending in order to put the unemployed to work. And while I certainly am not an expert in this field, in fact, I am anything but, I find it difficult to follow the reasoning that this drastic proposed cut of $10 billion or more is going to bring in more revenue and is going to stimulate our economy. I doubt whether it would accomplish those ends. And I agree with the Senator that the consumer sector of the public is what we should be concerned with, not the investment sector.

Senator GORE. Has my able colleague been laboring under the impression, the view which I had entertained, that when we are at a high level of prosperity the economy can afford a heavier burden of taxes and that if there is ever to be a balanced budget, the time to have it is at the time when you are at a peak of prosperity?

Senator GRUENING. I would agree with that.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Gruening.

Senator GRUENING. Thank you very much, Mr. Chairman.

The CHAIRMAN. Glad to have you with us.

Our next witness is Mr. David W. Richmond of the Investors Syndicate of America, Inc.

STATEMENT OF DAVID W. RICHMOND, INVESTORS SYNDICATE OF AMERICA, INC.

The CHAIRMAN. Mr. Richmond, take a seat.

Mr. RICHMOND. Mr. Chairman, members of the committee, my name is David W. Richmond. I am a partner in the Washington law firm of Miller & Chevalier. I represent Investors Syndicate of America, Inc., of Minneapolis, Minn. We urge the adoption of the amendment intended to be proposed by Senator McCarthy with respect to section 265(2) of the 1954 code. This amendment will make it clear to the Internal Revenue Service that Congress intended to permit Investors Syndicate to deduct from its gross income all interest which accrues to its certificate holders.

Investors Syndicate issues face amount certificates by which thousands of individuals throughout the country systematically invest their savings. For example, a certificate holder undertakes to pay to Investors Syndicate $33.40 a month for 20 years. At the end of 20 years, Investors Syndicate undertakes to pay the investor $10,000 which includes interest in accordance with the certificates provisions.

Investors Syndicate is subject to the Federal Investment Company Act of 1940; it is also subject to supervision and examination by the Banking Commissioner of the State of Minnesota. In accordance with the Investment Company Act, Investors Syndicate must invest a substantial part of the funds received from certificate holders in "qualified investments." The act provides that "qualified investments" include certain real estate mortgages, certain property improvement loans, U.S. Government and municipal bonds, and other securities meeting rigid performance standards. Since 1956, part of the funds paid to the company by its certificate holders has been invested in State and municipal bonds, the interest on which is exempt from Federal income tax.

Investors Syndicate deducts for Federal income tax purposes the interest which it must accrue each year to meet its obligations to its certificate holders. The Internal Revenue Service proposes to disallow that part of the deduction which corresponds to the ratio of Investors Syndicate's investment in tax-exempt State and municipal bonds to its total investment porfolio. In other words, if at the end of a given year, 20 percent of the portfolio of Investors Syndicate consisted of State and municipal bonds, the Service would disallow as a deduction 20 percent of the interest Investors Syndicate accrued on its certificates during that year.

The Service bases its action on section 265(2) which provides that "interest on indebtedness incurred or continued to purchase or carry" tax-exempt obligations shall not be deductible. We believe the proposed application of this section to Investors Syndicate is clearly

contrary to the intent of Congress; further, that it is an indirect attempt to tax the interest on State and municipal bonds.

The interest disallowance provisions now found in section 265(2) have been in the law since 1918. Congress early decided that if a taxpayer borrowed money for the purpose of buying a tax-exempt bond, he could not deduct the interest on the loan. In 1934, the Treasury proposed to Congress that if a taxpayer was paying interest on indebtedness and at the same time he owned tax-exempt bonds, a part of his interest deduction shall be disallowed. This result should follow, the Treasury said, whether or not the money had been borrowed for the purpose of buying the tax-exempt bond. It was pointed out that under then-existing law—

a taxpayer carrying on the banking business may deduct all the interest paid on deposits even though such deposits are invested in tax-exempt securities.

The House accepted the Treasury's recommendation. The Senate Finance Committee, however, refused to concur. It said in its report on the bill:

Your committee is of the opinion that the change made by the House bill will seriously interfere with the marketing of Government securities, which are bought for the most part by banks and financial institutions; and also presents grave administrative difficulties. Your committee, therefore, disagrees with the change made in this section by the House bill and recommends that the provisions of existing law be continued.

In conference, the House receded with this statement by its managers:

The Senate amendment restores the provisions of existing law; and the House recedes.

And what was existing law? It permitted a taxpayer carrying on the banking business to deduct all the interest paid on deposits even though such deposits are invested in whole or in part in tax-exempt securities. The law as it existed in 1934 remains substantially unchanged in section 265(2) of the present code.

Note that the interest disallowance provision did not apply to taxpayers "carrying on the banking business"; further, that this committee in 1934 recognized that tax-exempt Government securities are in its words, "brought for the most part by banks and financial institutions." Thus Congress intended to exclude from this provision not only banks but also taxpayers "carrying on the banking business" and "financial institutions."

What does "carrying on the banking business" mean in the scheme of Federal income taxation? The Internal Revenue Service has recently persuaded the Court of Appeals for the Ninth Circuit that:

* * * a Morris Plan company is a bank because it exercises the essential functions of a bank, which consist of receiving deposits and making loans and discounts, under strict legal supervision. There can be no question here that the Morris Plan company uses the moneys placed with it under thrift certificates in exactly the same way as a bank does deposits, i.e., to make loans secured by chattels. It seems equally clear that the moneys placed with a Morris Plan company by the public through thrift certificates, either in one lump sum or in continuing installments, are in all substantial respects like time deposits or savings accounts in a bank. Both the receipt of deposits and the making of loans by a Morris Plan company are subject to substantially the same type of State supervision as are banks. It is immaterial that a State law, which authorizes Morris Plan companies to exercise essential banking functions under its supervision, does not permit a Morris Plan company to call itself a "bank," or its accounts "deposits" (Government's brief in *Commissioner* v. *Valley Morris Plan*, CA 9, 305 F. 2d 610 (1963)).

In short, for the purpose of section 265(2) there is no difference between a commercial bank's indebtedness represented by deposits, the liability of a Morris Plan represented by its thrift certificates, and the liability of Investors Syndicate represented by its face amount certificates.

Yet the Internal Revenue Service is attempting to make a distinction. It issued a ruling on December 1, 1961, in which it recognized that the provisions of section 265(2) "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business." So far as it goes, this is clearly in accordance with congressional intent as expressed in the legislative history of the 1934 act. The Service refuses, however, to recognize the same inapplicability of this section to "financial institutions" like Investors Syndicate which also are taxpayers "carrying on the banking business."

The proposed amendment (No. 309) is necessary to require the Service to administer the law in accordance with the intent of Congress as expressed in the report of the Senate Finance Committee on the 1934 act. The complete legislative history is set forth in a memorandum attached to my statement; I ask that it be printed in the record.

The CHAIRMAN. Without objection.

(The document referred to follows:)

MEMORANDUM OF INVESTORS SYNDICATE OF AMERICA IN SUPPORT OF PROPOSED AMENDMENT TO H.R. 8363 WITH RESPECT TO INTEREST RELATING TO TAX-EXEMPT INCOME

Investors Syndicate of America (ISA) urges the Senate Finance Committee to adopt the amendment to be proposed by Senator McCarthy to H.R. 8363 which would add a new sentence to section 265(2) of the Internal Revenue Code of 1954. We believe this sentence is necessary to forestall action by the Internal Revenue Service which is directly contrary to the intent of Congress as expressed in a report of this committee made in 1934.

Section 265(2) presently provides—

"No deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations * * * the interest on which is wholly exempt from the taxes imposed by this subtitle."

The Internal Revenue Service proposes to apply section 265(2) to certain deductions claimed by ISA on its income tax return. The result of such application would be a partial disallowance of these deductions. The portion disallowed would be computed on the basis of the ratio that the investments of ISA in tax exempt obligations bear to its total investments.

We believe that this disallowance is contrary to the clear intention of Congress as expressed in the report of the Senate Finance Committee on the Revenue Act of 1934, the most recent occasion on which it considered the provision which is now section 265(2).

ISA issues face-amount certificates which provide a systematic plan for the accumulation of funds. A certificate holder undertakes to pay to ISA a certain amount at stated intervals and at the end of a stated period, ISA undertakes to pay the face amount of the certificate which includes an increment of a fixed amount at a stated rate. ISA is subject to the Investment Company Act of 1940 which requires that the greater part of the company's funds must be invested in "qualified investments" as defined in the act. Generally speaking, "qualified investments" include real estate mortgages, property improvement loans insured under title I of the National Housing Act. U.S. Government and municipal bonds, and other securities meeting rigid performance standards. The medium of investment which ISA chooses among the several "qualified investments" for the money paid in depends on the various economic and financial considerations present at the time the money becomes available.

Since the face amount payable at maturity is more than the amount paid in by the holder, ISA accrues each year and deducts for Federal income tax purposes a ratable part of the increment necessary to pay the face amount of the certificate at maturity. During 1956 and subsequent years, some part of ISA assets has been invested in tax-exempt obligations.

In all material respects the provisions of section 265(2) have remained unchanged since 1918 although an effort was made to amend these provisions in 1921 and again in 1934. The legislative history of the amendment proposed in 1934 demonstrates that section 265(2) has no application to interest paid or accrued by Investors Syndicate.

The predecessor to section 265(2) in the Revenue Act of 1932 was section 23(b) which provided for deductions as follows:

"(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except (1) on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) and interest upon which is wholly exempt from the taxes imposed by this title,* * *."

On December 4, 1933, the Subcommittee on Tax Revision of the Ways and Means Committee reported its recommendations to the full committee and made the following statement with respect to amending section 23(b) (p. 13):

"(2) INTEREST ON MONEY BORROWED TO PURCHASE TAX-EXEMPT SECURITIES.—Section 23(b) of the Revenue Act of 1932 prohibits the deduction of interest on indebtedness incurred or continued to purchase or carry tax-exempt securities.

"It appears that under the present wording of the law deposits in banks are not treated as indebtedness incurred to purchase such securities. Therefore, a taxpayer carrying on the banking business may deduct all the interest paid on deposits even though such deposits are invested in tax-exempt securities. Your subcommittee believes that interest paid on deposits invested in tax-exempt securities should be disallowed as a deduction for income-tax purposes. A change in the wording of this section is, therefore, recommended to accomplish this result."

Thereafter, the revenue bill of 1934 (H.R. 7835, 73d Cong.) was reported by the Ways and Means Committee and contained the following provision—section 23(b):

"In computing net income there shall be allowed as deductions:

* * * * * * *

"(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except (1) on indebtedness incurred or continued to purchase or carry, *or the proceeds of which were used to purchase or carry,* obligations ~~or securities~~ (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title, or (2) * * *." (Words added are in italic; words eliminated are stricken through.)

The Committee's report on this section stated:

"SEC. 23(b). Deductions from gross income-interest: Section 23(b) of existing law prohibits the deducation of interest on indebtedness incurred or continued to purchase or carry tax-exempt securities. Thus, indebtedness incurred by a bank on its deposits is not treated under existing law as indebtedness incurred or continued to purchase or carry tax-exempt securities. Therefore, a taxpayer carrying on the banking business may deduct all the interest paid on deposits even though such deposits are invested in tax-exempt securities. * * * This section of the bill provides that if the proceeds of indebtedness, such as bank deposits, are actually used to purchase or carry tax-exempt securities, no deduction shall be allowed for the interest incurred on such indebtedness" (H. Rept. 704, 73d Cong., 2d sess., pp. 21–22).

The bill passed the House as reported by the Ways and Means Committee. However, in the bill reported by the Senate Finance Committee, section 23(b) was amended in the following respect:

"In computing net income there shall be allowed as deductions:

* * * * * * *

"(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title."

The effect of this amendment was to restore in all material respects the original text of this provision as it appeared in the Revenue Act of 1932 and earlier acts, and in its report the Senate Finance Committee said:

"Section 23(b) of existing law prohibits the deduction of interest paid or accrued on indebtedness incurred or continued to purchase or carry tax-exempt securities. The indebtedness incurred by a bank to its depositors is not treated under existing law as indebtedness incurred or continued to purchase or carry tax-exempt securities. This section of the House bill provides that if the proceeds of indebtedness, such as bank deposits, are actually used to purchase or carry tax-exempt securities, no deduction shall be allowed for the interest incurred on such indebtedness. *Your committee is of the opinion that the change made by the House bill will seriously interfere with the marketing of Government securities, which are bought for the most part by banks and financial institutions; and also presents grave administrative difficulties.* Your committee, therefore, disagrees with the change made in this section by the House bill and recommends that the provisions of existing law be continued." [Emphasis added.] S. Rept. 558, 73d Cong., 2d sess., p. 24.)

The Senate version of section 23(b) prevailed and in the statement of the managers on the part of the House in the conference report on H.R. 7835 there appears the following:

"Amendment No. 17: Under existing law interest paid on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) is not allowed as a deduction if the interest received on such obligations is wholly exempt from income taxes. *The House bill also denies the deduction if the proceeds of such indebtedness were used to purchase or carry such obligations, regardless of the purpose of the taxpayer in incurring such indebtedness. The Senate amendment restores the provisions of existing law; and the House recedes.*" [Emphasis added.] (H. Rept. 1385, 73d Cong., 2d sess., p. 17.)

Two conclusions follow from this legislative history. The first conclusion is that Congress intended that section 265(2) should not apply merely because the proceeds of indebtedness are actually used to purchase or carry tax-exempt securities. For section 265(2) to apply, the indebtedness must be incurred or continued for the purpose of buying and carrying such securities.

The second conclusion is that Congress considered, as did the Treasury, that the requisite relationship between the indebtedness and the purchase of tax-exempt securities does not exist with respect to proceeds of indebtedness "such as bank deposits." The reason for this is clear. Bank deposits are not received or solicited in order that the depositary may buy tax-exempt securities. Whether, in fact, the depositary actually uses the deposits for such a purpose depends upon many factors, such as the availability of other loans or equity investments and the prevailing interest rates on tax-exempt securities as compared with other investments.

The face amount certificates issued by ISA, and ISA's use of moneys deposited with it by the certificate holders, are in the context of the question involved indistinguishable from ordinary bank deposits. ISA neither receives nor solicits such moneys for the purpose of buying tax-exempt securities. When it receives the money, it has a general purpose to invest it—as does a bank—but whether it uses such moneys to buy tax-exempt securities, or to make real estate loans, or to acquire equity investments, or to make commercial loans depends on the same general factors that govern a commercial bank's use of its deposits.

In short, for this purpose there is no difference between a commercial bank's indebtedness represented by deposits and ISA's liability represented by face amount certificates. The Commissioner has, in other contexts, recognized that this is so. In *Commissioner* v. *Valley Morris Plan*, CA 9, 305 F. 2d 610 (1962), the Commissioner has recently successfully argued that the Morris Plan company "is a bank" and that Morris Plan thrift certificates, which are similar to ISA face amount certificates, "represent deposits in a bank." The Commissioner's brief in that case states (pp. 16–17):

"We submit that a Morris Plan company is a bank because it exercises the essential functions of a bank, which consist of receiving deposits and making loans and discounts, under strict legal supervision. There can be no question here that the Morris Plan company uses the moneys placed with it under thrift certificates in exactly the same way as a bank does deposits, i.e., to make loans secured by chattels. It seems equally clear that the moneys placed with a Morris Plan company by the public through thrift certificates, either in one lump

sum or in continuing installments, are in all substantial respects like time deposits or savings accounts in a bank. Both the receipt of deposits and the making of loans by a Morris Plan company are subject to substantially the same type of State supervision as are banks. It is immaterial that a State law, which authorizes Morris Plan companies to exercise essential banking functions under its supervision, does not permit a Morris Plan company to call itself a 'bank,' or its accounts 'deposits.'"

Thus, the Morris Plan's thrift certificates and the use of the proceeds thereof, which are in essence like ISA's, are recognized by the Commissioner (and the Ninth Circuit) to be the same as bank deposits. No different result should be expected from the Commissioner in this case just because a different section of the law is involved.

In TIR 348, dated December 1, 1961, a copy of which it attached, the Service ruled that section 265(2) should "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business." We see no basis for any distinction between "banks engaged in the general banking business" and other "banks and financial institutions" mentioned in the report of this committee on the 1934 act, which also purchase tax-exempt securities in the course of carrying on a general financial business. Congress clearly directed that section 265(2) was not to be applied merely because the proceeds of indebtedness were used to purchase or carry tax-exempt obligations. Further, Congress in 1934 confirmed that section 265(2) applies only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities, and pointed out that the proscribed purpose is not present when banks and financial institutions purchase tax exempt with money placed with them by the general public.

Since Congress, speaking through the Finance Committee, clearly said that section 265(2) should not apply to "banks and financial institutions," and since the Treasury by TIR 348 has specifically ruled that banks are not subject to section 265(2), we must conclude that the Treasury believes that ISA is not described by the term "financial institutions" as used by the Senate Finance Committee. We believe this term, as used in the legislative history of the 1934 act, was intended to cover organizations who perform functions in the nature of banking but which would not ordinarily be referred to as banks. We believe that there was no congressional intent to discriminate in favor of banks and against financial institutions, but rather to include within the intent not only organizations which would be generally recognized as banks but other corporations carrying on the same essential banking functions.

In other words, we consider that ISA is a financial institution which Congress intended should be treated like a bank because it has the essential characteristics of a bank. The Internal Revenue Service argued successfully in the *Valley Morris Plan* case that the essential functions of a bank "consist of receiving deposits and making loans and discounts, under strict legal supervision." The Internal Revenue Service also argued successfully that the moneys placed by the public through thrift certificates (similar to ISA face-amount certificates) "are in all substantial respects like time deposits or savings accounts in a bank."

Our position is supported by very recent congressional action. In adding section 401(d)(1) in the Revenue Act of 1962, Congress required that the trustee of certain trusts must be a bank and then defined bank to include "a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or other officer of such State in charge of the administration of the banking laws of such State." ISA is such a corporation—it was incorporated in Minnesota and it is subject to supervision and examination by the banking commissioner of that State. It is clear from the legislative history of this section that ISA is a bank within the meaning of section 401(d)(1), see Senate hearings on H.R. 10, page 169, and Senate Report 992, 87th Congress, page 31.

Congress plainly indicated its awareness in 1962—as it had in 1934—of the fact that there are financial institutions not commonly called banks which nevertheless should be included in that term because there is no real difference in their functions.

For the purpose of section 265(2), it seems clear that ISA is either a bank or a financial institution or both. Further, Congress has made it clear that the proscribed purpose in section 265(2) is not present in the case of "banks and financial institutions" merely because they may invest the money they accept from the public in tax-exempt securities. Therefore we believe that discrimina-

tion against ISA in favor of ordinary banks with respect to the deductibility of interests costs incurred would be inequitable and contrary to the clear intent of Congress.

U.S. TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
PUBLIC INFORMATION DIVISION,
December 1, 1961.

TECHNICAL INFORMATION RELEASE

The Internal Revenue Service announced today that the provisions of section 265(2) of the Internal Revenue Code of 1954 have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations * * *" within the meaning of section 265. The Service explained that section 265(2) provides for the nondeductibility of interest on indebtedness incurred to purchase or carry certain obligations on which the interest is exempt from Federal income tax.

The Service stated that although this has long been the position of the national office of the Service, no specific publication of this point had been made.

The Service said that its announcement results from its consideration of a request for advice from a field office where the problem had arisen in connection with the examination of the return of a bank by a revenue agent.

Mr. RICHMOND. We respectfully urge the adoption of this amendment by the committee.

Thank you.

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

Any questions?

Thank you, sir.

The next witness is Mr. Paul D. Seghers, Institute on U.S. Taxation of Foreign Income, Inc.

Proceed, sir.

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.

Mr. SEGHERS. My name is Paul D. Seghers, attorney, New York, and I appear as president of the Institute on U.S. Taxation of Foreign Income, Inc.

I have prepared a condensed oral presentation and ask leave of the chairman to file in the next few days a complete statement. (The complete statement will be made a part of the committee files when received.)

Our appearance before your committee is to speak out in opposition to the amendments to H.R. 8363 proposed by the distinguished member of your committee, Senator Gore, and to urge upon the committee the great need for tax measures to encourage our foreign trade and the manufacture of goods in this country for sale abroad.

In view of President Johnson's praiseworthy pronouncements regarding Government economy in spending, it may be appropriate to quote very briefly what was said about "Federal Tax Reform—The Practitioner's Viewpoint," less than a month ago:

Unlimited spending causes literally unbearable taxation.

The heaviest tax, the most desructive and most difficult to repeal, is that exacted by inflation. Reduced Government spending, permitting reduced tax exactions, is the tax reform most critically needed today.

We would be blind and worse than blind if we refused to proclaim this warning, before undertaking to make recommendations for specific reforms in methods of taxation.

We oppose both Senator Gore's proposed substitution of a radically new and harsher subpart F and the present (1962) subpart F which taxes U.S. shareholders of controlled foreign corporations on the imaginary receipt of imaginary dividends, measured by the hypothetical increase in the value of property. Such a tax is an unconstitutional and fantastic levy.

Senator GORE. In other words, if I understand you, you not only oppose the amendment that I have suggested but you oppose even the limited action that the Congress took last year in this field.

Mr. SEGHERS. It is far from limited and very harmful as I will explain in a few moments.

Senator GORE. I will strike out the "limited." You opposed even what Congress did in this regard last year.

Mr. SEGHERS. I do.

Senator GORE. And you want it repealed.

Mr. SEGHERS. I would like to see that repealed.

Senator GORE. Thank you, Mr. Chairman.

Mr. SEGHERS. Instead of penalizing U.S. taxpayers that expand the commerce of this country into other lands, our Government should offer incentives to encourage the sale of our products abroad and all other forms of foreign commerce which have the effect of enriching our economy.

Your committee and the House Ways and Means Committee last year were deluged with facts, figures, and arguments showing that, over the preceding 10 years, U.S. business abroad had resulted in a tremendous favorable international balance of trade (surplus of commercial inflow of funds over outgo) in favor of this country, and setting forth the reasons for this surplus. Anyone who has considered these facts and arguments should realize that it is U.S. Government expenditures abroad, greatly exceeding this commercial surplus, which result in the enormous deficits in our international balance of payments.

Our foreign trade, our income from that trade, and our favorable international balance of trade, would today be far less favorable, and our international balance of payments disastrously worse than they now are, had the 1962 tax changes been enacted 10 years earlier.

During the past 15 months many relatively small U.S. manufacturers thatw ould, under prior law, have organized a foreign corporation to market their products abroad, have been deterred by the 1962 law from entering or expanding in this field. The reasons include the direct tax penalty; the frustrating complexity of the radically new provisions of the law and related regulations; the adverse publicity designed to discredit those engaged in foreign trade; and the burdensome accounting and reporting requirements under the new law. Business can't help feeling that it just isn't worth taking the risk in view of all this additional expense and trouble. What has hurt most is the repudiation by the Government of its long-maintained policy of encouraging expansion of U.S. commerce abroad.

That subpart F penalizes any method of doing business abroad which would minimize foreign income taxes on income earned in foreign countries by a foreign corporation, may seem unbelievable, but the technicians of the staff of the joint congressional committee will, it is believed, confirm this fact.

The new law penalizes income earned abroad by a foreign subsidiary from sales abroad, to unrelated buyers, of goods produced by and purchased from its U.S. parent company. However, if that same foreign corporation's selling efforts are diverted to the sale of goods produced abroad by foreign-owned factories, the resulting income is not penalized under the existing law.

SUBPART F

(1) Is unconstitutional, being a tax on a mere assumed increment in value of property. Congress indeeed has the power to levy such a tax, but only by apportionment, as prescribed in the Constitution, and not as an income tax.

(2) Is an unbelievably complicated, frustrating, burdensome, and unjust substitute for efficient, diligent, conscientious administration of preexisting law.

(3) Serves only to collect tax in advance on what would, under prior law, become taxable as soon as realized by any person or corporation subject to U.S. income tax; and

(4) Imposes almost unbearably heavy burdens of compliance by methods more costly than justified by the resulting tax revenues.

Subpart F of the code penalizes U.S. manufacturers selling their goods to foreign subsidiaries which actively merchandise such goods abroad. It should be repealed before it has done more harm to existing oversea business operations of U.S.-owned subsidiaries. It will choke off some expansion and already operates as a barrier to the large number of small U.S. manufacturers who were thinking of entering that field.

EVILS INHERENT IN THE COMPLEXITY OF SUBPART F

The fantastic complexity of subpart F is best illustrated by the difficulties which the Treasury is having with the formulation of regulations thereunder.

The Treasury's proposed but unissued regulations regarding "minimum distributions" will run to more than 180 pages on that one small segment of the problem. An article in the Tax Law Review on the problem of determining what constitutes "ownership" and "control" under subpart F fills 40 pages, of which about half consists of footnotes in very small type, and that again only a small segment of the law. And I would like to supply to the committee for its files, not for inclusion in the record, three copies of that article, reprints.

The complexity of these radically new provisions of the Internal Revenue Code and regulations are not merely a matter of wording and form, but much more of substance. When U.S. taxpayers are required to report as taxable income the imaginary receipt of imaginary dividends, that is only the opening act of the phantasy. Then comes the credit for the foreign tax which would be allowable if a real dividend were really received. There also follows the necessity of providing for the addition to the cost of the stock of the foreign corporation (for U.S. income tax purposes) on account of the imaginary receipt of the imaginary dividend. Then there are provisions to reverse the whole process when a real dividend actually is received—the exclusion from taxable income of such real dividends to the extent already taxed as imaginary dividends; disallowance of the foregoing tax credit to the

extent duplicated by the credit already allowed on account of the imaginary receipt of the imaginary dividend, and a reduction in the "basis" (tax cost) of the foreign stock to eliminate the additions thereto previously made to reflect the imaginary receipt of the imaginary dividend. And that is only the normal, typical case.

If the taxpayer properly elects, he may pay the tax on the imaginary dividend as if it had been received by an imaginary U.S. corporation; with further complexities if and when he actually receives a real dividend, to the extent previously taxed as an imaginary dividend.

It seems clear that we should get back down to earth rather than continue this nightmare which has many other fantastic turns and twists. Imagine the effect of explaining all this, and many other perplexing provisions, to a U.S. manufacturer who would like to build up sales of his products abroad.

Subpart F has added a heavy burden of cost of compliance; the labor and expense of preparing numerous detailed reports and returns; the heavier added cost of all the new accounting records now required to be kept, analyses prepared, and detailed records assembled, filed, and preserved indefinitely.

Heavier than all these burdens is the demand on the time and energies of top executives, in assuring themselves that all these essential functions are performed, and that every available means is utilized to insure that the taxes thus to be paid are no more than required under the law. This consumes time, energy, and money which otherwise would be turned to productive use.

THE NEED TO REPEAL THE NEW (1962) "GROSS-UP" PROVISIONS

Under the radically new (1962) foreign tax credit "gross-up" provisions, a U.S. corporation which receives a dividend from a foreign corporation (whether controlled or not) is required, in order to obtain the foreign tax credit to which it is entitled, to report as taxable income the amount of foreign income tax paid to any foreign government by the dividend-paying foreign corporation. This results in taxing as an imaginary dividend an amount which the U.S. taxpayer has not earned, has not received, and never can receive.

The misleading mathematics and reasoning used by the Treasury in urging this 1962 amendment were brought to the attention of your committee in our April 26, 1962, appearance (hearings on H.R. 10650, p. 2912). Our statement clearly showed, in a computation using the same figures as the Treasury's that, under the provisions of law then long in effect, the U.S. taxpayer corporation:

(1) Was taxed at the full U.S. income tax rate on the full amount of the dividend that it received from the foreign corporation.

(2) Got credit only for the portion of the foreign income tax paid by the foreign corporations on the amount of the dividend it paid to the U.S. taxpayer.

(3) Got no tax benefit from the portion of the foreign income tax paid by the foreign corporation on the portion of its income the foreign corporation used to pay its own foreign income tax.

If continued in effect, these "gross-up" provisions, in conjunction with the new subpart F, would:

(1) Give further encouragement to foreign governments to raise their effective rates of income tax on U.S.-owned businesses (at least up to the maximum U.S. rate);

(2) Remove the preexisting incentive U.S.-owned foreign businesses formerly had to take all feasible steps to pay as little foreign income taxes as possible; and, therefore,

(3) Result in less tax revenue to the U.S. Treasury.

Your committee can verify this by obtaining from the Treasury statistics showing what percentage of U.S. income tax on dividends received by U.S. corporations from foreign corporations, actually has been collected by the U.S. Treasury in recent years. This will show that foreign governments continually increase the percentage of their tax "take" from the income of our oversea businesses, leaving less and less net tax to be actually collected by our Treasury. The Treasury has promised such statistics, but they have not yet been made available even to Congress.

The 1962 "gross-up" provisions handicap U.S.-owned business abroad in its efforts to meet foreign competition; they reduce U.S. tax revenues; and they are harmful to our economy. The foreign tax credit provisions in effect for many years have worked well, and under them U.S. foreign trade has greatly increased; our export sales (without which there can be no U.S. production for export) have greatly expanded; and we have enjoyed a very favorable international balance-of-trade position, thereby reducing the deficit in our international balance of payments.

The 1962 changes in the foreign tax credit provisions should be repealed and those in effect prior to the 1962 act should be reinstated.

THE NEED FOR EXPORT TAX INCENTIVES

Committee 1 on Tax Policies and Export Expansion, of the September 1963 White House Conference on Export Expansion, created by our late President Kennedy, recommended a reduction in the U.S. tax on the foreign income of domestic corporations qualifying as "export trade corporations," along lines similar to the provisions of the 1959 Boggs bill. That Committee also recommended an incentive credit against the tax on income resulting from the increase in the amount of the taxpayer's export of goods produced in this country; and that the tax reduction be large enough to provide a real incentive.

Tax incentives to encourage the manufacture of goods for export (and their sale abroad, without which there can be no profits to tax), could effect a desperately needed increase in our factory payrolls and in our domestic economy in general—but more than merely cautious, half-promises are needed.

The proposed export tax incentive would have to be limited in its application to the increase in the amount of the taxpayer's export sales of U.S. products. The tax reduction should be substantial (not less than 14 percentage points), and not subject to any irrelevant limitations.

The United States would thereby benefit greatly from the resulting:

(1) Increased employment and factory payrolls here at home;

(2) Increased income of domestic suppliers, attributable to the increase in other factory outlays (also resulting in increased payrolls); and

(3) Increased receipts of funds from abroad.

The report of the President's Committee 1 very effectively presents the reason for this form of tax incentive.

CONCLUSION

Without well-organized U.S. selling activities abroad, sales of U.S. products abroad cannot be substantially increased, and only to the extent that such sales are increased, can U.S. production of goods for export be increased. Subpart F is cleverly designed to penalize and choke off such U.S. oversea sales activities.

Many of the members of this institute, when asked for their recommendations concerning an incentive to increase exports, expressed very strongly the view that the pre-1962 law was a most effective export incentive and that repeal of subpart F and of "gross-up" would be more effective than any other form of tax incentive.

This would cause a new wave of expansion of business at home and abroad and greatly improve our international balance-of-payments position. These benefits would be enhanced if some form of export tax incentive were enacted.

I regret that Senator Gore is no longer here to question some of these statement. I thought he was interested in them.

Thank you for the opportunity.

The CHAIRMAN. Thank you very much, sir.

Any questions?

Thank you very much, sir.

The next witness is Mr. Lincoln Arnold of the American Mining Congress.

STATEMENT OF LINCOLN ARNOLD, CHAIRMAN OF THE TAX COMMITTEE, AMERICAN MINING CONGRESS

The CHAIRMAN. Mr. Arnold, take a seat, sir.

Mr. ARNOLD. Mr. Chairman, my name is Lincoln Arnold. I practice law here in Washington, D.C., as a member of the law firm of Alvord & Alvord. However, today I am appearing before this committee 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 of the various branches of the mining industry, including coal, ferrous and nonferrous metals, and industrial minerals.

This morning I intend to limit my testimony to two amendments that have been proposed to the tax bill, and which are of most importance to our members. However, before the close of these hearings the American Mining Congress will submit for the record a supplemental statement which will present our views on a number of other provisions of the bill and which we now ask to be associated with this testimony.

(The supplemental statement referred to follows Mr. Arnold's oral testimony.)

Today, I will confine my remarks to Senator Gruening's amendment, No. 204, which would remove the limitations on the deductibility of exploration expenditures, and Senator Hartke's amendment, No. 319, which would direct the Secretary of the Treasury to incorporate into the depreciation regulations useful lives (for the categories of tangible property described in Revenue Procedure 62-21, and its modifications), lives which are no longer than those specified in that revenue ruling, and which would permit taxpayers the option of adopting the prescribed useful lives without regard to the taxpayers' replacement practices.

SENATOR GRUENING'S AMENDMENT NO. 204

We urge the adoption of amendment No. 204 proposed by Senator Gruening, of Alaska (cosponsored by Senators Bartlett, Democrat, of Alaska; Bible, Democrat, of Nevada; Humphrey, Democrat, of Minnesota; Long, Democrat, of Missouri; McGovern, Democrat, of South Dakota; Moss, Democrat, of Utah; and Mundt, Republican, of South Dakota; which would remove the present limitations on the deductibility of exploration expenditures. Exploration expenditures are the research expenditures of the mining industry and as such should be as fully deductible as are the research expenditures of other industries.

When a mineral deposit is exhausted, it cannot be replaced like machinery. One cannot order a new deposit from the factory. More than 10 years ago the Paley report (report of President Truman's Materials Policy Commission), after pointing out that the allowance of exploration costs affords an incentive "for capital to take risks in highly uncertain fields," recommended:

> That the present limitation applicable to minerals other than oil and gas on the amount of permitted expensing of exploration costs be removed.

In 1959 Congress enacted, with revisions, H.R. 4251—the Howard Baker bill—which afforded some relief from the severe restrictions previously in effect on the deductibility of exploration expenditures. But the deduction of these expenditures is still limited to $400,000 for the lifetime of any given taxpayer—an amount which is far too small to suit the needs of a mining company which must regularly search for new reserves.

In the declaration of policy adopted by the members of the American Mining Congress in September of this year, it is stated in part, as follows:

> The costs, the risks, and the failures in finding, developing, and producing minerals from new reserves to replace those exhausted are constantly increasing * * *. Exploration expenditures, like other research expenditures, should be fully deductible and present limitations on deductibility of exploration expenditures should be removed.

There is no question but that the complete deductibility of these exploration expenditures would stimulate new exploration and increase employment.

The adoption of Senator Gruening's amendment, in addition to serving the public interest, would also eliminate an area of considerable controversy that has developed between the Internal Revenue Service

and the mining taxpayers, involving the dividing line between exploration and development costs.

Under section 615, of the Internal Revenue Code, which Senator Gruening's amendment would modify, expenditures incurred for the purpose of—

ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine or deposit—

are defined as exploration costs. As previously stated, a mining taxpayer may deduct only $400,000 of such expenditures at a rate of not more than $100,000 a year.

Under section 616 of the code, development expenditures are deductible without limitation and are defined as—

all expenditures paid or incurred * * * for the development of a mine or other natural deposit * * * after the existence of ores or minerals in commercially marketable quantities has been disclosed.

In order to limit as much as possible the expenditures incurred in the development of a mine, some Internal Revenue agents have adopted a rule for determining—

the beginning of the development stage—

which contravenes the clear words of section 616(a) that the development stages commences—

after the existence of ores or minerals in commercially marketable quantities has been disclosed.

These field agents have superimposed on this sole test other requirements in order to delay the beginning of the development stage—requirements which extend the exploration stage and which we believe are clearly countrary to the regulations as well as the statute.

We have some hope that the national office of the Internal Revenue Service will, at an early date, correct this situation. In any event, the adoption of Senator Gruening's amendment will remove this serious area of controversy for future taxable years.

Since Senator Gruening's amendment refers only to exploration expenditures paid or incurred before the beginning of the development stage of the mine, the question might be raised as to the deduction of such expenditures made after the beginning of the development stage of the mine. The answer to that question is that such expenditures made during the development stage will be deductible without limitation, as under existing law, as development expenditures, and if made during the producing stage of the mine they will be deductible without limitation, as under existing law, as operating expenses.

We understand that Senator Gruening's amendment to remove all limitations on the deduction of exploration expenditures was prepared with assistance from the Treasury Department, and we agree that it is not necessary for the amendment to refer to exploration expenditures which are incurred after the beginning of the development stage of the mine or deposit.

Senator DOUGLAS. Just a minute. You say Senator Gruening's amendment was prepared with the assistance of the Treasury Department? Does this mean that it was prepared with their approval?

Mr. ARNOLD. No, sir; it does not. We know Senator Gruening requested the Treasury, as a drafting service, to prepare an amendment for him that would eliminate all the limitations, but he specifically did not ask for their approval of it. Whether the Treasury approves or disapproves I cannot state.

With respect to Senator Hartke's amendment No. 319, at our annual metal mining and industrial minerals convention, held his year in Los Angeles in September, our membership adopted the following position with respect to the Treasury's new depreciation guidelines:

We commend last year's administrative promulgation of shorter depreciation "guideline lives," but further action is needed. To preserve the simplicity and the certainty of the principle of guideline lives, this principle should be enacted into law, without limitation through application of the reserve ratio test.

Senator Hartke's amendment would accomplish the objective of this policy statement, and therefore the American Mining Congress strongly urges its adoption by the Senate Finance Committee as an amendment to H.R. 8363.

One of the important objectives of the depreciation guideline ruling in 1962 was to eliminate the controversies between taxpayers and the Internal Revenue Service over depreciation allowances. The guideline ruling should reduce much of the administrative difficulties involved in this area.

However, expensive and time-consuming arguments over depreciation allowances will certainly occur unless the reserve ratio test is eliminated. We fear that, at the end of the 3-year grace period, taxpayers will be entangled in administrative uncertainties and complexities involved in complying with the uncertain and vague principles of the reserve ratio test. The requirement that this test must be met will, to a large extent, nullify the stimulation of our economy, which was the primary objective of the ruling.

Furthermore, since most taxpayers will have adopted the new guidelines for the 3-year grace period, the revenue loss to the Treasury Department by the removal of the reserve ratio test should be negligible.

The adoption of Senator Hartke's amendment, together with the removal of the present provision of existing law requiring that the depreciable base of property qualifying for the investment credit be reduced by the amount of the credit, will have a substantial bolstering effect on our Nation's economy and reduce expensive and burdensome recordkeeping and accounting procedures.

We agree wholeheartedly with the following remarks which Senator Hartke made on October 10 of this year on the floor of the Senate with respect to application of the reserve ratio test:

Uncertainty and complications arising from the administrative decisions of the Treasury are preventing the full operation of the intended liberalization, and therefore preventing new investment in plant and equipment sorely needed to further stimulate the economy.

* * * * * * *

The difficulties, both for the taxpayer and the Internal Revenue Service, of attempting to administer a procedure which calls for a strange mixture of judgment, prophecy, and higher mathematics on the part of both taxpayer and revenue agent would be avoided.

Most significant, the passage of the proposed legislation should have little or no adverse revenue effect. As long as guideline depreciation is operating, the

revenue effect cannot be changed during the 3-year transition period. As the bill I am introducing closely approximates the results of the 1962 revenue procedure, there will be no different revenue effect than the continuation of the present system.

The purpose of the legislation is to give an assurance of certainty and continuity to the best features of guideline depreciation and to make the administration of the depreciation deduction simple and positive rather than to reduce taxes.

Thank you for giving me an opportuniy to appear before your committee.

The CHAIRMAN. Thank you, Mr. Arnold.

Any questions?

Senator DOUGLAS. Mr. Arnold, in your statement, you speak of the reserve ratio test as embodying uncertain and vague principles.

Mr. ARNOLD. Yes, sir.

Senator DOUGLAS. Now, in what way is this test vague and uncertain?

Mr. ARNOLD. Well, Senator, the reserve ratio test—I cannot say that I fully understand it. I can say this, that I have studied it and I do not know precisely how it is to be applied. As yet we do not have to apply it, but the observation I have made here is not unusual. It is difficult to apply after reading what the Treasury itself announces as the rules.

My comment is the same comment that Senator Hartke made on the floor of the Senate.

Senator DOUGLAS. I understand.

Mr. ARNOLD. That it calls for a strange mixture of judgment, prophecy, and higher mathematics.

Senator DOUGLAS. In what way does it require prophecy and in what way does it require higher mathematics?

Mr. ARNOLD. I wish I had a copy of the tables that accompanied the reserve ratio application with me. I do not have it. I would be very happy to insert it in the record.

Senator DOUGLAS. It seems to me you are making vague charges which you do not support in practice. I am speaking lightly in this matter.

Mr. ARNOLD. Well, I do not have it with me. I am remiss in not having with me a copy of the instructions which have been issued for applying the reserve ratio test when and if it has to be applied. They are complicated, Senator.

Senator DOUGLAS. Are you then possibly attacking a danger which is not present and will never be put into effect?

Mr. ARNOLD. Well, we hope—I hope we are. I hope that the reserve ratio test will never be in effect. We are asking that it not ever come into effect.

Senator DOUGLAS. Just what is the reserve ratio?

Mr. ARNOLD. Well, roughly it is this—for 3 years taxpayers can use the guideline lives. In the case of mining equipment it is 10 years. The taxpayer engaged in mining can just take his cost of his mine equipment and take 10 percent of it and deduct it without challenge for a period of 3 years. Then at the end of the 3-year period, which has been called the grace period—an agent will look at the total cost of the taxpayer's mining equipment and then look at his depreciation reserves and to find out whether he has a replacement

practice that will justify the 10-year guideline life. There are tables set up so this man can be checked out.

If the reserve for depreciation is too high in accordance with these tables, then it means that he is no longer entitled to use the 10-year test. But it gets complicated because you have to know whether this taxpayer is growing, is just standing still, or whether he is reducing his investments on a growth pattern, and this produces greater complications.

I do not pretend that I understand just how they work. But the idea is simply this—during the 3-year period, the taxpayer cannot be challenged on using a 10-year life for mining equipment. After the 3-year period the agent can quarrel with him as to whether that produces a proper result, and there is supposed to be a mechanical test of how does your reserve for depreciation as compared to the total amount you have got in your depreciation account check out against the tables.

Senator DOUGLAS. Well, on the surface I don't see what is wrong with that. But perhaps you have further information.

Let me ask you this. You represent the American Mining Congress?

Mr. ARNOLD. I do, sir.

Senator DOUGLAS. As you know, the House inserted in the bill the provision that royalties from iron mines will be subject not to income taxation but to capital gains. Do you approve of that?

Mr. ARNOLD. The American Mining Congress is going to file a statement for the record on a number of the provisions of the bill, including that section which I believe is 218 of the bill. Just let me check it. And that statement will state that the American Mining Congress opposes the enactment of that provision.

Senator DOUGLAS. This is very interesting. Why do you do that?

Mr. ARNOLD. Well, if I might state——

Senator DOUGLAS. Did the mining companies of the Mesabi Range approve of your opposition to this provision?

Mr. ARNOLD. I am sure it will come as no surprise to you, Senator, if I say this was not a unanimous decision of the members of the Tax Committee of the American Mining Congress. I can state, I think without any exception, the coal representatives on the—the representatives of the coal industry on the committee did not like the decision made by the majority of the committee.

Senator DOUGLAS. And I take it the iron mining interests did not.

Mr. ARNOLD. Generally speaking; but there were some exceptions, the iron ore industry, the operators, those who pay the royalties were in favor of our position that we are taking. We do not have on the Tax Committee of the American Mining Congress people who merely sit in the position of receiving royalties.

In other words, the lessors. The royalty recipients are not represented on the Tax Committee of the American Mining Congress.

Senator DOUGLAS. May I ask this question? As you know, we are getting iron ore in increasing proportions from Labrador.

Mr. ARNOLD. Yes, sir.

Senator DOUGLAS. The Humphrey group is interested in Labrador, as are the Eaton group and others. Is it your understanding that the substitution of capital gains taxation for income taxation on these royalties applies to income from the Labrador operations as well as from the Mesabi Range operations?

Mr. ARNOLD. I think there is no question but what the bill does apply to royalties from deposits outside the United States.

Senator DOUGLAS. Well, I had thought that you would come out in enthusiastic endorsement of this measure and I must say I am startled, pleasantly startled, by your statement. I wondered if you would expand this a bit.

I may find an unexpected ally here. This is always welcome. It is like a dividend which comes without anticipation.

Mr. ARNOLD. First let me make it clear that I am quite sure that if you ask the lessors of iron ore properties whether they are in favor of the bill, they will be strongly in favor of the provision giving capital gains.

Senator DOUGLAS. That is true. Now——

Mr. ARNOLD. We represent for the most part the operators, the people who pay royalties, not those who receive them, although some of our members do both.

Senator DOUGLAS. Don't you like to have your customers prosper? If they can pay only half the taxes that they otherwise would, and perhaps, if the capital gains provision of the House bill is retained, pay only 40 percent of the taxes which they otherwise would pay, I should think that they would prosper and you would like this. The more they prosper the more they can pay you.

Mr. ARNOLD. We are not trying to be nasty with the recipients of the royalties, Senator.

Senator DOUGLAS. I am trying to get at your——

Mr. ARNOLD. The basis for it—I can state briefly what is really the basis for it. Capital gains—if something is a capital gain to the recipient, it would indicate he sold a capital asset. That is the normal basis for it. If the receipient of the royalty is receiving the proceeds from the sale of a capital asset, isn't the payor buying a capital asset? Under the present law, the general approach is that payment of royalties is not considered the purchase of an asset but as an operating expense.

Now, the Supreme Court stated in this area, in *Burton-Sutton Oil v. Commission*, 328 U.S., and it was talking about payments received by a royalty holder, it said as follows:

If they—

the payments—

are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other.

Now, the legislation does say that notwithstanding that you get capital gain for the recipient, the tax treatment of the payment should be treated just as if this provision had not been enacted. That is in the present law on coal royalties. The fear——

Senator DOUGLAS. You mean the present law or the present bill?

Mr. ARNOLD. It is in the present law with respect to coal royalties. And the same rules would apply here.

Senator DOUGLAS. That is right.

Mr. ARNOLD. You see, when coal royalties received capital gain treatment back in 1951, there was some fear, well, if it is a capital gain to the recipient, it is a capital purchase by the payor and a pro-

vision was carefully put into the statute by this committee, the Senate Finance Committee, when the bill came over from the House to make it clear that there would be no change—that the tax treatment of the payment of the royalty would not be changed by making it capital gain to the recipient, and that provision would also apply to the iron ore royalties.

Now, I am repeating myself, but let me just sum it up. There is a fear among a number of the members of the Tax Committee of the American Mining Congress that if you extend capital gains treatment to royalties, that the Treasury might come up with the idea, well, let's treat it as a purchase of a capital asset and make them capitalize it and recover it through depletion rather than deduct them as an operating expense.

It is that simple.

Senator DOUGLAS. Well, it is not simple to me.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. No questions.

The CHAIRMAN. Thank you very much.

(The supplemental statement follows:)

STATEMENT OF LINCOLN ARNOLD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS, ON TAX REDUCTION

Mr. Chairman, the American Mining Congress believes that Congress should reduce the burden of Federal income taxation as soon as possible in order to bolster and stimulate the economy of our Nation. However, we believe that the emphasis in any tax reduction program should be placed on encouraging new investments in productive machinery and equipment. Such a program would more likely achieve the expansion of our economy necessary to provide full employment and to bring about a full utilization of our idle plant capacity. We believe that a tax reduction developed along these lines will, in the long run, result in increased revenues to the Treasury and an eventual reduction of our national debt.

The American Mining Congress regrets that the Ways and Means Committee has tied tax reduction with certain structural changes in our tax laws. This has already delayed and will continue to delay the enactment of much needed tax reduction legislation and result in inadequate consideration of the structural proposals contained in the bill. Structural changes should be considered and studied separate and apart from tax reduction so that decisions with respect to them may be determined on their own merits, and not in any way as a quid pro quo for a tax reduction.

CURRENT TAX PAYMENTS

Section 122 of the bill would, over a 7-year period, place corporations on a pay-as-you-go basis with respect to their tax liabilities in excess of $100,000. Declarations of estimated tax would be payable in four installments, on April 15, June 15, September 15, and December 15, for a calendar year corporation, with comparable dates for filing declarations and for payments provided for fiscal year corporations.

This section would continue in effect the 6-percent penalty provision of the present law for underpayments. There is an underpayment unless the estimated tax payments:

(1) Amount to 70 percent of the tax shown on the final return after subtracting $100,000 and allowing credits; or

(2) Amount to as much as the previous year's tax reduced by $100,000; or

(3) Are equal to what last year's tax (less $100,000 and allowable credits) would have been had current rates been applicable to that year's income, or unless

(4) The installment with respect to the declaration for any quarter is equal to 70 percent of the tax (less $100,000 and allowable credits) due on the basis of the income received to date, placed on an annual basis.

The American Mining Congress recommends that the April 15 date for filing declarations of estimated tax and for the making of the first payment should be delayed 30 days—to May 15. This would give the corporations the opportunity to use the data and information as to their first quarterly operations in preparing the declaration of estimated tax, and thus make it possible for a more accurate estimation. The date of April 15 is too close to the end of the first quarter for most corporations to accumulate the data and prepare the financial statements. Similarly, there should be a 30-day delay of the June 15, September 15, and December 15 dates for payment applicable to calendar year taxpayers.

In addition, the Mining Congress urges that the 70-percent tests set forth in (1) and (4) above should both be reduced to 50-percent tests, at least in the case of the mining industry. The taxable incomes of mining companies are difficult to estimate because of the variables involved in computing the depletion deduction and, in many cases, because of the seasonal nature of their operations.

Depletion is computed on a property-by-property basis, requiring a separate determination of both gross income and taxable income for each particular property for the entire taxable year. These computations involve complicated valuation and allocation problems which, in most cases, depend upon factors which are available only at the end of the taxable year and which vary from property to property. They require such determinations as (1) the representative market or field price of the mineral product, (2) the relationship of the costs of mining processes to the costs of nonmining processes, and (3) the allocation of overhead costs to the various separate properties and between the mining and nonmining operations. In addition, a decision must be made as to whether exploration and development expenditures should be deducted or deferred. All of these determinations can only be made after the data with respect to the full year's operation have been established, and can only be guessed at during the year.

It is recommended that a 50-percent test be made applicable to taxpayers whose estimated "gross income from mining," as defined in section 613(c), for the taxable year is at least 50 percent of the total estimated gross income from all sources for the taxable year.

ELIMINATION OF THE 4-PERCENT CREDIT FOR DIVIDENDS RECEIVED BY INDIVIDUALS

Section 201 of the bill would eliminate, over a 2-year period, the present 4-percent credit allowed against tax for dividends received by individuals. The American Mining Congress urges the Senate Finance Committee to reject this provision of H.R. 8363 as a step backward in the removal of the existing double taxation involved in the distribution of dividends to shareholders. Our membership has repeatedly included as a part of the Mining Congress' policy the position that the "limited allowance now made to stockholders on dividends with respect to taxes paid by the corporation should not be reduced but, rather, increased." It is our view that, if the existing small relief from double taxation cannot be increased, Congress should at least refrain from eliminating it.

INVESTMENT CREDIT

Section 202 of the bill, among other things, provides for the repeal of the requirement that the basis of property on which investment credit is allowable be reduced by the amount of the credit received. In other words, if property is acquired for $100 which is eligible for the 7-percent credit, the basis of this property must be reduced to $93 and depreciation taken on that amount. If section 202 is adopted, this requirement would be eliminated and depreciation would be taken on the full purchase price of $100.

The American Mining Congress urges the enactment of this provision. This requirement has created unsolvable problems and costly and complicated recordkeeping, and has reduced the effectiveness of the basic credit. It diminishes the incentive effect of the credit since it cuts the benefits of the credit approximately in half. A person entitled to the 7-percent credit must restore approximately one-half of the benefits over the useful life of the asset involved.

In addition, we urge that the taxpayers have the right to elect the investment credit with respect to each asset. Under present law, the credit is mandatory.

At our Los Angeles convention, held in September of this year, the membership of the Mining Congress adopted as part of its declaration of policy on taxation the following resolution with respect to the investment credit:

"The provision of the tax laws which allows a credit against tax of 7 percent of the cost of new investments in tangible depreciable property should be made elective. We urge the approval by Congress of the recent decision of the House Ways and Means Committee to repeal the existing requirement that the tax basis of property be reduced by the amount of the investment credit."

INTEREST ON CERTAIN DEFERRED PAYMENTS

Section 215 of the bill provides that in the case of any contract for the sale or exchange of property for a sales price exceeding $3,000, which provides little or no interest on deferred payments and where some or all of the payments are due more than 1 year after the date of the sale or exchange, a portion of the payments due more than 6 months after the date of the sale or exchange must be treated as interest, both as to the buyer and as to the seller. This treatment would also apply to deferred payments for which liability is uncertain or which are indefinite as to amount or due date.

The American Mining Congress first wants to state that this section will affect many transactions which actually involve no interest, and will place in the hands of revenue agents authority to revise agreements in a manner not intended by the parties to the transactions. It will also create an additional area of controversy between revenue agents and taxpayers for negligible revenue gain.

However, we specifically object to the application of the imputed interest concept to indefinite deferred payments involved in sales of mineral properties where the deferred payments are based upon the amount of minerals produced or the amount of reserves remaining in the ground. These situations occur where the seller does not desire to retain an economic interest in the mineral property, but to have the buyer definitely liable for the payment of whatever amount the production of minerals or the remaining reserves call for. These situations arise as the result of disagreements between the seller and the buyer over the amount of mineral reserves. The case of *Estate of Bessie E. Macris*, 34 T.C. 827, involved this type of transaction.

In December 1951 the taxpayer sold her shares of stock in the Wilshire Oil Co. for about $9 million, on the basis that the reserves amounted to 4,500,000 barrels. It was agreed that the properties might contain additional oil reserves and that the taxpayer would be paid additional amounts for her stock based upon later determinations of the existence of additional oil reserves in the property. The purchasers were to pay 50 cents a barrel for the oil reserves in excess of 4 million and up to 16 million barrels. The estimates of additional reserves were to be made each year until October 1, 1961. The taxpayer received additional payments both in 1952 and 1953, based on engineering estimates of additional proven reserves.

The Mining Congress does not believe that this type of transaction should be governed by section 215, simply because it is obvious that the parties had no intention of drafting the agreement in such a way as to avoid an interest factor. The nature of mineral properties is such that it is often impossible at any specific time either to agree upon or to determine the exact amount of minerals available. The geologists and mining engineers do not yet possess adequate scientific tools to make such determinations, and it therefore becomes necessary for the passage of time to produce the additional information required to complete mineral transactions.

TREATMENT OF IRON ORE ROYALTIES

Section 218 of the bill would accord capital gains treatment to income from iron ore royalties. The American Mining Congress opposes the adoption of this section. Present law correctly holds that mineral leasing transactions are not capital in nature and that royalty payments by a lessee are properly deductible as operating costs in the production and sale of minerals by mining companies.

We do not know of any reason why iron ore royalties should receive special treatment.

The CHAIRMAN. The next witness is Mr. Rolla D. Campbell of the National Council of Coal Lessors, Inc.

Take a seat, Mr. Campbell. Proceed.

STATEMENT OF ROLLA D. CAMPBELL, NATIONAL COUNCIL OF COAL LESSORS, INC.

Mr. CAMPBELL. Mr. Chairman and gentlemen of the Finance Committee, I am Rolla D. Campbell, of Huntington, W. Va., and senior partner in the law firm of Campbell, McNeer, Woods, Bagley & Emerson.

I have practiced law for about 40 years. I have had the privilege of appearing before this committee and the House Ways and Means Committee on a number of occasions in the past with reference to matters of importance to the coal industry. Today I appear for National Council of Coal Lessors, Inc., a trade association representing coal lessors whose properties are located in the various coal-producing districts of this country. I am president of the council.

Statements on behalf of the council were made before the House Ways and Means Committee by Mr. J. M. B. Lewis, Jr., of Roanoke, Va., and myself addressed to certain of the President's proposals. They are found in the hearings before the Committee on Ways and Means, held on March 25, 1963. A summary of the points therein urged is attached hereto.

The position of the council with reference to these points is unchanged. The council also supported the proposals made before the Ways and Means Committee by National Coal Association on the same day, and still does.

My statement today is addressed primarily to certain portions of H.R. 8363 as passed by the House. I have tried to keep it brief.

REDUCTION IN TAX RATES

I am strongly in favor of a reduction of present income tax rates, because, in my opinion, existing rates are too high and have passed the point of diminishing returns. This is not a new notion for me. I expressed the same opinion before the Ways and Means Committee in the fall of 1959 when hearings were held on various methods of broadening the tax base.

I am not an economist, and my views are not based on a knowledge of statistical data. They are based upon my personal observations in my daily law practice. Almost every business or property transaction today is examined first as to the kind and amount of taxes involved. All too often the tax consequences either kill the proposed transaction or force it into forms the parties dislike.

Almost daily I see evidence of individual taxpayers who deliberately limit their taxable earnings in exchange for time off or reduced efforts. I do not think this Nation can afford to put a tax handicap on productive effort. Yet current income tax rates do exactly that.

In my opinion, existing rates on capital gains are also too high. I know of a substantial number of situations where the taxpayer feels, rightly or wrongly, that he is locked in because of the large tax he would have to pay if he realized on his paper gains, even though, in my judgment, he would be wise to sell, pay the tax, and diversify.

Therefore, I respectfully submit that, in my opinion, lower rates on individuals, on corporations, and on capital gains will produce more, not less, tax revenue. And, thinking this way, I suggest that H.R. 8363 should be described as a bill to increase the tax revenues by lowering the rates and not, as I frequently hear, as a bill to reduce taxes.

RATES ON INDIVIDUAL INCOMES

The reductions recommended by the House are good as far as they go. Personally, I think they do not grant enough relief to the middle and higher brackets and that they give too much relief to the lower brackets. After all, the revenue produced from individuals by the rates above the basic 20-percent rate is only about one-seventh of the total taxes paid by individuals. It does not take much net income to get into the brackets above 20 percent, and the upward progression thereafter is quite rapid. If the rates in the current bill are to be left undisturbed the brackets for each individual rate should be widened.

RATES ON CORPORATE INCOMES

I am pleased to see these rates reduced, especially on the first $25,000 of taxable income. The increase to the higher rate of 48 percent on the excess above the first $25,000 of income is too abrupt, in my opinion, and should be stepped up by easier stages. I would like to see a bigger reduction than 4 percentage points in the higher—52 percent—rate.

The proposed advances in the payment dates of taxes by corporations with incomes in excess of $100,000 are, in my judgment, a means of denying any actual benefit to such corporations during the years current status is being attained. The actual benefits of lower rates during those years will come only to such corporations as become bankrupt or are voluntarily liquidated. These are not the corporations which would respond to the investment incentives of the prospect of lower rates several years hence. I would make the tax reductions effective for all corporations and omit the effort to put the larger corporations on a current basis.

RATES ON CAPITAL GAINS

I am delighted to note in the bill that it contains some recognition of the need to reduce rates on long-term capital gains. I have two suggestions: The bill should extend lower rates to corporations and it should provide progressively lower rates for longer holding periods. The bill makes a start in reducing some rates to apply for a holding period of more than 2 years, and I hope this start will be expanded by this committee.

CLASS B CAPITAL GAINS

I disagree with the denial of the lower rates to cerrtain class B capital gains. The class B capital gains to which I refer are gains realized by: the cutting of timber—code, section 631(a); disposal of timber with a retained economic interest—code, section 631(b); disposal of coal with a retained economic interest—code, section 631(c); disposal of iron ore with a retained economic interest—bill, section 218; sale of livestock held more than 12 months for draft, breeding, or dairy purposes—code, section 1231(b)(3); sale of land held for more than 6 months with unharvested crop thereon—code, section 1231(b)(4); sale of certain patent rights held for more than 6 months by individuals whose efforts created the patent rights sold—code, section 1235; receipt of certain employee termination payments—code, section 1240; and receipt of lump-sum payments under qualified pension, profit-sharing, or stock bonus plans—code, sections 402 and 403.

All of the gains so listed have, after hearings and careful consideration by the Ways and Means Committee and this honorable committee, and by the House of Representatives and the Senate, been properly classified as entitled to capital gains treatment. Certainly, I know that is the case with respect to section 631(c) relating to coal royalties. The reasons for lowering the rates on these transactions are just as valid as those for reducing the rates on class A gains. I respectfully urge that the lower rates of the bill be extended to corporations and to all gainst now specifically defined in the code or the bill as capital gains, and that the rates be progressively lowered as the holding period increases. I urge the deletion of section 219(a) (2), (3), (4), and (5) of the bill, which define the above list of gains as class B gains.

DIVIDEND CREDIT FOR INDIVIDUALS—AND OTHER RELIEF FROM DOUBLE TAXATION OF CORPORATION EARNINGS

I sincerely hope that the dividend credit now accorded by the code to individuals will not only be retained but will be increased above 4 percent.

All of us concerned with taxes desire to stimulate investments in capital assets. One method of stimulating such investments is to reduce as much as possible the double taxation of corporate earnings. Another method would be to extend the scope of the regulated investment company and the real estate investment trust provisions to other corporations which consistently distribute at least 90 percent of their incomes nad gains to their shareholders. In either case, there would be heavy pressure on corporations to disburse a larger part of their earnings and the total revenues of the Government would thereby increase, investment would be encouraged, and consumer spending would be increased.

If these suggestions are too costly, then I suggest that coal royalty income—and other income similarly treated—should not be disqualifying income for a real estate investment trust. The Internal Revenue Service has, in its regulations, approved such income as qualified for subchapter S companies but has refused to do so for real estate investment trusts. If this committee should agree with me, the following amendment to the code is suggested for incorporation in the bill:

Amend the definition of "interests in real property" in section 856 (c)(6)(C) of the Internal Revenue Code of 1954 to read as follows—new material italicized:

(C) The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon *and retained economic interests in coal subject to section 631(c)*, but does not include mineral, oil, or gas royalty interests.

If this is not done, then I respectfully suggest that coal royalty income be considered as capital gains not required to be distributed by corporations subject to subchapter G of the code. The requirement of distribution is the result of the last sentence of code section 631(c), which sentence was added in 1951 in order to make some minor changes in the 1951 revenue bill which had passed both House and Senate, in different forms, and was revised by the conferees, and then unexpectedly rejected by the House—and thereby to bring the changed

bill back to the House where it was passed. It was never originally intended to be a part of the law and was added only as an afterthought to cure a procedural difficulty as between the House and the Senate. This suggestion can be carried into effect by the elimination of the last sentence of section 631(c). It would then be comparable to section 631(b) relating to gains from the disposition of timber with a retained economic interest.

DEFICIT SPENDING

Personally, I am opposed to deficit spending, excepting only in the direst emergencies. But spending by the Federal Government lies solely within the control of the Congress which has the power of the purse. I sincerely hope that the Congress will reduce tax rates, that it will not stop in doing so with this bill, and that it will regulate its spending proclivities so as to avoid deficits. Indeed, I would like to see adopted a program of debt reduction to be consistently followed through the ups and downs of the economic cycles. I can think of nothing which would do more to encourage investments and stimulate business and increase the tax revenues than a consistent program of budget surpluses applied to debt reduction.

A NEEDED CORRECTION OF THE RECORD

Page 94 of the Ways and Means Committee report to accompany H.R. 8363 contains the following statement relative to capital gains for iron ore lessors (H.Rept. 749 (88th Cong., 1st sess.)):

This capital gains treatment is available only to lessors who are not themselves participants in the production of the iron ore either as coadventurers, partners, or principals.

This statement is an erroneous paraphrase of the substance of the existing sentence in code section 631(c) applicable to coal, which reads:

"This subsection shall not apply to *income realized* by any owner *as* a coadventurer, partner, or principal in the mining of such coal * * *." [Italic ours.]

The remaining part of this sentence reads:

* * * and the word "owner" means any person who owns an economic interest in coal in place, including a sublessor.

This was added in the 1954 Revenue Act to correct a misinterpretation by the Internal Revenue Service.

This point is specifically discussed in hearings on the 1951 revenue bill before this committee when I was testifying in support of the coal lessor amendment to the 1939 code (sec. 117(k)(2)) (hearings before the Committee on Finance, U.S. Senate (82d Cong., 1st sess.); "Revenue Act of 1951," pt. 2, pp. 675-677 (1951)). It was there brought out by Senators Kerr and Millikin that a lessor receiving coal royalties from a mineral deposit might also have a working interest in the profits from producing minerals from the same deposit and the language should be clear that the capital gains treatment of the coal royalties should not deny percentage depletion to income from the working interest. But the language quoted from the report says, improperly, that a lessor cannot receive capital gains taxation of his

royalties if he has a working interest in the mining, and should be corrected to conform to the plain meaning of the words in code section 631(2).

I might say that the language now in the law was put there for the very purpose of avoiding the interpretation given in the report which is here criticized.

ELIMINATION OF REDUCTION OF BASIS BY INVESTMENT TAX CREDIT

The elimination of the requirement that basis of any depreciable property giving rise to an investment tax credit be reduced by the amount of the credit, as proposed in the bill (sec. 202), is proper and should be retained by this committee.

I am grateful for the honor and privilege of being permitted to appear before you on this most important subject.

Thank you.

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

Mr. CAMPBELL. Mr. Chairman, attached to the paper is the summary of the position taken before the House Ways and Means Committee.

The CHAIRMAN. Without objection, that will be inserted in the record.

(The document referred to follows:)

SUMMARY OF POSITIONS OF NATIONAL COUNCIL OF COAL LESSORS, INC., BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON MARCH 25, 1963

(Attachment to statement of Rolla D. Campbell, president, National Council of Coal Lessors, Inc., before the Finance Committee, U.S. Senate, Dec. 4, 1963)

FAVORED POSITIONS TAKEN ON SAME DATE BY NATIONAL COAL ASSOCIATION

1. Opposed the proposal of the President to repeal capital gains for coal royalties paid under newly made leases; and described fully the provisions of code section 631(c) and the reasons therefor. The committee is respectfully referred to the text of my statement before the Ways and Means Committee.

2. Favored the proposal of the President to substitute 30-percent inclusion factor for the existing 50-percent inclusion factor in taxing capital gains and to extend the short-term holding period from 6 to 12 months; and suggested that corporations be taxed at the same rate on capital gains as individuals, that the rates should progress downward as the holding period increases, and favored the longer carry forward of capital losses.

3. Opposed the proposal of the President to tax at death or at gift accrued but unrealized capital gains.

4. Opposed the proposal of the President to eliminate capital gains taxation on profits realized on the sale of mineral interests; the proposal, if adopted, would have inflicted a tax penalty on percentage depletion taxpayers.

5. Opposed the President's proposal to tax depreciation deductions recaptured from proceeds of sale of depreciable real estate insofar as the same applied to depreciable improvements of mines entering into the computation of the 50-percent limitation factor in percentage depletion.

6. Opposed the President's proposal to tighten the personal holding company provisions by redefining personal holding company income.

7. Favored reductions in rates applicable to individuals but suggested greater reductions in rates and widening of brackets applicable to incomes taxable at rates above the basic 20-percent rate.

8. Favored reduction of corporate rate to 47 percent at once; suggested a more gradual step-up in the rate on corporate incomes above $25,000 until the maximum rate is reached; and opposed the proposal of the President to accelerate payment of corporate taxes on incomes in excess of $100,000.

Senator DOUGLAS. May I ask a question?

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS Mr. Campbell, you say that you think there should be a program of debt reduction which should be consistently followed through both the ups and downs of the economic system, and therefore, as you say in the next sentence, you favor budget surpluses at all times. Is that correct?

Mr. CAMPBELL. Yes; I think that is an idea which Congress should try.

Senator DOUGLAS. This would, of course, mean in practice that you would have to have a Government surplus in a period of depression because you would have to have the surplus in order to retire a portion of the debt.

Mr. CAMPBELL. That is correct.

Senator DOUGLAS. Now, during that depression you have governmental revenues falling off very rapidly due to the shrinkage in income, and indeed governmental revenues decline by more—proportionately more—than the decrease in the national income because of the importance of the corporate tax, corporate income tax.

So that in order to realize your program of a surplus in a period of depression when revenues are falling very rapidly, you would have to increase tax rates during a depression.

Mr. CAMPBELL. Well, that would be true, Senator, if Congress continues to rely so heavily for its revenues on taxation of net incomes.

Now, one of the criticisms which has been made of our whole tax structure is that too much reliance is placed upon a highly variable source of income.

Senator DOUGLAS. Would you substitute for income taxes, then, sales taxes?

Mr. CAMPBELL. A transaction tax.

Senator DOUGLAS. Transaction?

Mr. CAMPBELL. The National Association of Manufacturers proposed such a program some years ago and I think it was a very well thought out program.

Senator DOUGLAS. Of course, now this would be highly regressive, would fall more heavily upon the lower income groups than upon the upper income groups since they spend a larger fraction of their income for commodities and the upper income groups spend a larger fraction of their income on services.

Mr. CAMPBELL. Senator Douglas, I think there might be some dispute as between the theoreticians as to whether such a tax would be regressive or not.

Senator DOUGLAS. Oh, I don't think there can be any dispute about it. All the budget studies show that as income goes up, the percentage spent on commodities goes down and the percentage spent on services goes up. Every budget study in the country shows this.

Mr. CAMPBELL. Well, many income taxes, I mean, State taxes, are based upon income from services as well as sales of commodities.

Senator DOUGLAS. Very few.

Mr. CAMPBELL. I mean sales taxes.

Senator DOUGLAS. Most of them are retail sales taxes and these are clearly regressive.

Mr. CAMPBELL. In our State of West Virginia we have a gross tax on income from services and where services are rendered, there is a State sales tax on services.

Senator DOUGLAS. I know, but the prevailing practice is for the tax to be levied on retail sales of commodities and, as I understand it, this is the proposal of the Manufacturers Association, a percentage to be levied at the manufacturing level.

Mr. CAMPBELL. Of course, you realize there are some theoreticians who also say that income taxes are passed on to the public in the form of higher prices and higher wages and higher salaries since they are treated as part of the costs of the operation. So that I don't know if there was any choice between the two, with respect to whether it is passed on or not, that you can make any proper choice.

Senator DOUGLAS. I have never heard a claim that individual income taxes were costed to be paid after receipt of income.

Mr. CAMPBELL. Yes. I know that is true, but when I read these statements from corporations about the salaries of corporate employees, high executives, they always have two statements: how much the pay was before taxes and how much the pay was after taxes, indicating that the rate of pay was set high in order to provide a take-home living for the officers.

Well, now, if that isn't true that the taxes are passed on I don't know what is. But, frankly, on the question of the philosophy of taxation, I am of the opinion, based upon what I see in my daily law practice, that too much reliance is placed by the U.S. Government on revenue from a variable source which make it almost impossible for the Congress to predict what its revenue is going to be in any particular year, particularly where it has to make the predictions a year or two ahead of time.

Now, you wouldn't have that variability if you had the source of taxation from a more stable source. And another thing that was raised here this morning that I think we have got to face some day is the tremendous amount of income that is exempt from Federal income tax because it is paid by State and political subdivisions on their indebtedness. Of course, that comes not by virtue of any act of Congress but as a result of a decision of the Supreme Court of the United States, and it probably would take a constitutional amendment to change it. But I think the day is going to come when that big source of untaxed income is going to have to be eliminated and be made subject to tax. And I frankly hope to see the day when that will come.

Senator DOUGLAS. Now, you represent organized groups which receive coal royalties?

Mr. CAMPBELL. That is correct.

Senator DOUGLAS. What is your attitude toward the provision in the House bill which provides that iron ore royalties shall not be taxed as individual income but as capital gains and therefore subjected as to a much lower rate of taxation than if taxed as individual income?

Mr. CAMPBELL. I wor ; think, Senator Douglas, that our members would favor such an amendment. Personally, I do. I think they have made a——

Senator DOUGLAS. You differ from the American Mining Congress.

Mr. CAMPBELL. Oh, yes.

Senator DOUGLAS. Their representative opposes it.

Mr. CAMPBELL. Oh, yes. I would say the position of the American Mining Congress does not represent the views of any coal landowner or any coal producer other than the captive coal mines of the large steel companies who are also operators, lessees, of iron ore mines.

Senator DOUGLAS. Why do you suppose they oppose it?

Mr. CAMPBELL. Beg pardon?

Senator DOUGLAS. Why do they oppose it? I must say I am somewhat mystified by the explanation of the learned counsel who just testified.

Mr. CAMPBELL. Senator Douglas, I can't tell you the real reason for it. I do know this, that there has been considerable litigation between the iron ore operators and the fee owners, as they are called, the lessors, over a number of different questions, and I don't think that they are too friendly with each other from what I can hear.

Now, I can't verify that statement.

Senator DOUGLAS. Let me ask you this question, then. Have the owners of the captive mines, railways and in some cases I believe steel companies, opposed the treatment of royalties from coal mines as capital gains, rather than as income?

Mr. CAMPBELL. No, they have not.

Senator DOUGLAS. They have not.

Mr. CAMPBELL. No, sir. And as I understand, there is no such opposition to the coal provisions.

Senator DOUGLAS. Would you favor the extension of this treatment of royalties as capital gains rather than income to copper mines?

Mr. CAMPBELL. Well, I don't know enough about the copper industry to be able to say.

Senator DOUGLAS. If it is good for coal and iron, wouldn't it be good for copper?

Mr. CAMPBELL. As I say, I don't know enough about the facts of the industry.

Senator DOUGLAS. I mean logically.

Mr. CAMPBELL. Well, if you have any comparable situation as we had in the coal industry, of course I would favor it.

Senator DOUGLAS. You would do this.

Mr. CAMPBELL. But I don't know if we have a comparable situation.

Senator DOUGLAS. Would you favor it for uranium?

Mr. CAMPBELL. I don't know the story on uranium.

Senator DOUGLAS. Do you favor the depletion allowance for coal?

Mr. CAMPBELL. You mean the percentage depletion allowance?

Senator DOUGLAS. Yes.

Mr. CAMPBELL. For the coal mining companies? Oh, yes.

Senator DOUGLAS. Well, if this is extended to uranium, then, would you favor the extension of the capital gains treatment to royalties of uranium?

Mr. CAMPBELL. Senator, I have to plead ignorance of the facts relating to those industries. I am thoroughly aware of the facts pertaining to the coal industry. I have lived in it all my life. I hope I can answer most any question you can ask about coal, but about these other minerals I know nothing.

Senator DOUGLAS. You are an expert on the extractive industry.

Mr. CAMPBELL. No, on coal; as it applies to coal.

Senator DOUGLAS. Would you favor the extension of capital gains treatment to royalties from sand and gravel, clamshells, oystershells, and the rest which are given a percentage depletion?

Mr. CAMPBELL. Well, they have that through existing court decisions. They don't need any legislative treatment.

Senator DOUGLAS. You mean in the case of clamshells and oystershells.

Mr. CAMPBELL. Yes. They have revised forms of dealing with——

Senator DOUGLAS. Those aren't treated as capital gains.

Mr. CAMPBELL. Which qualify as——

Senator DOUGLAS. I think you are an expert after all on these subjects. Is this true on sand and gravel also?

Mr. CAMPBELL. I think so, very largely.

Senator DOUGLAS. Well, if it is true of sand and gravel and coal, why not extend it to uranium and copper and zinc and lead?

Mr. CAMPBELL. Well, Senator, if you have——

Senator DOUGLAS. Oil and gas?

Mr. CAMPBELL. The oil and gas people don't want it. They are happy the way they are.

Senator DOUGLAS. You mean they have enough as it is.

Thank you.

Senator BENNETT. I am puzzled by the Senator's questioning. The sand and gravel people get a depletion allowance but they don't get a capital gains treatment.

Mr. CAMPBELL. Not by virtue of any——

Senator DOUGLAS. I would be surprised if they did.

Senator BENNETT. That is a thing I want to clear up for the record. Do they get a capital gains treatment as a rule?

Mr. CAMPBELL. If they write their papers in the correct way, they do.

Senator WILLIAMS. And still retain ownership of the same gravel pit or sand pit, or do they have to transfer the ownership?

Mr. CAMPBELL. Oh, they retain the ownership of the land that is left after the gravel is removed. But it is primarily the question of the form of the transaction.

One of the reasons that we urged this treatment for coal in the beginning was that sale of coal in place measured in any manner except by weight qualified for capital gains. The traditional method of determining the thing sold under the standard form of coal mining is to measure the unit of sale by weight, by the ton, but if you sell by the acre, by the square yard, by the cubic foot that you can identify, why then you had a capital gains transaction. We said that there shouldn't be a difference in tax rate based on a unit of measurement of the thing sold; and the Ways and Means Committee and the Senate Finance Committee agreed with us on that.

Senator BENNETT. I see.

The CHAIRMAN. Any further questions?

Senator BENNETT. No.

The CHAIRMAN. Thank you very much.

Mr. CAMPBELL. Thank you very much, Mr. Chairman.

The CHAIRMAN. The next witness is Mr. Lee C. Bradley, Jr., of White, Bradley, Arant, All & Rose.

Take a seat, sir, and proceed.

STATEMENT OF LEE C. BRADLEY, JR., BRADLEY, ARANT, ROSE, ALL & WHITE, BIRMINGHAM, ALA.

Mr. BRADLEY. My name is Lee C. Bradley, Jr., and I am a partner in the firm of Bradley, Arant, Rose, All & White of Birmingham, Ala. I deal primarily with some of the evidential problems that will be involved in the proposal to impose on the estate of decedents a tax corresponding with the present tax on capital gains and the alternative which has been advanced providing for the carryover of basis to the estates of beneficiaries and deceased persons.

Although those proposals were not carried into the House bill, they have as I understand it been renewed in the statement by the Secretary of the Treasury.

They present serious evidential problems that may affect every substantial estate or the legatee of any estate. Technically I do not represent any specific client but on the reasonable assumption that the present theories of taxation would continue in effect, we have advised the clients to pay taxes on capital gains at the corporate level which would not have been imposed if the corporation had been liquidated with the effects provided for in section 337 of the 1954 code.

We feel that those taxpayers should be given specific consideration.

In the proposals I have mentioned we are dealing with a tax imposed on an estate after death or with the carryover of basis of deceased persons. Thus we start with a basic hypothesis that the witness who is presumably cognizant of the facts about costs and possibly the only witness who could testify thereto of his own personal knowledge is unavailable because of his death. The basis may also be fixed by value at a given date, the legal effects of a given transaction, and how the transaction was handled on income tax return.

In some of these instances the United States itself has introduced an obstacle to proof by ordinary standards as the result of a systematic destruction of income tax returns and audit information.

Basis may be fixed by value on March 1, 1913, or even prior thereto, or by value at a later date when a transaction might have occurred or when some but not all of a block of stock acquired at different times has been disposed of, whether that which was sold was identified or the "last in, first out" presumption had been applied. These events may have occurred long ago. The hearsay rule, the best evidence rule, and the principle that a witness can testify only to facts within his personal knowledge present the major obstacles to proof of events which may have occurred 20, 30, 40, 50 or more years before. Records set up by a taxpayer are neither self-proving nor conclusive even during his life, and are suspect as self-serving declarations made with a motive to misrepresent.

Application of the standards involved in the application of these rules could result in the imposition of very unjust tax burdens because of the presumption in favor of determinations by the Commissioner and the burdens of proof imposed on the taxpayer in tax litigation. It would be unjust to require taxpayers to rely on the possible indulgence of representatives of the Internal Revenue Service or even the courts.

In this connection we should remember that the basis of the estates of deceased persons and of beneficiaries of those estates has always heretofore been established at the value of the property at the death of the decedent or at the distribution. Under present evidential standards, records which might now be set up to show basis by one who will be dead at the time the tax accrues would not be receivable because they were not made in the regular course of business, contemporaneously with the transaction, and might be excluded on the theory that they were the equivalent of entries made after suit had been begun with a motive to misrepresent.

If the contentions as to bases which might be recorded in those records take account of sales and dispositions of property acquired at different times, the taxpayer would be confronted with the difficulty of proof presented by the destruction of income tax returns and audits.

Thus we can have the equivalent of a tax at the applicable capital gain rates on the entire value of the estate of a decedent or the entire sales price of property inherited from a decedent. Taxpayers who would be affected by taxation at the ordinary rates, of certain gains on the disposition of real property, will have an additional problem of proof, namely, the allocation of sales price or value as between improvements and land.

In whatever terms a statute may be framed, in any of these cases it will be true that the Commissioner will be able to make arbitrary determinations of basis or allocation of sales price or value which will be difficult or substantially impossible to overturn by any method or standard of proof or evidence which is now recognized.

It appears to me that there is some inconsistency in the positions which were advanced by advocates of these proposals. Proponents of the bill urge that tax reduction will so favorably affect the economy that the tax yield will be larger and that in the House committee report is related to the capital gains tax itself. But these proposals are urged to avoid a decrease in yield from the tax on capital gains.

As the report of the Ways and Means Committee indicates, a mere reduction in rate could forestall such a result and would certainly help with the locked-in problem.

There is another objection to the proposal for a carryover on basis because it can be more easily made retroactive in its impact if it be not restricted to the estates and beneficiaries of decedents who die after the passage of the statute. The substitute can be more objectionable than the basic proposal. If a cutoff be considered, it should certainly be accompanied by provisions for relief in cases of later exchanges and other transactions which do not involve a change in basis.

The Secretary of the Treasury opposed the cutoff provision but even that would appear to need some amplification.

In my opinion the tax on long-term capital gains presently in effect already contemplates substantial taxation of capital as distinguished from income in numerous instances. The proposals have been advanced on the assumption that only true income will be made the subject of tax. This is not a completely accurate assumption since numerous taxpayers acquired property which may be the subject of sale many years before the sale. In that interim there have been in

the past, and can be in the future, extensive changes in price levels which would be the occasion of taxation of taxable gain as defined in the code without any improvement whatever in the relative economic position of the taxpayer who sells the property.

Some of these changes in price level are preferable to inflationary considerations, the significance of which may not be mathematically demonstrated, but the effects of evaluation can be fixed mathematically by allowing a 66⅔-percent increase in basis over cost.

On reading the report of the Ways and Means Committee on the 1962 act, I found that the committee includes a sentence in dealing with section 1245 of the code which supports that view. With your indulgence I will read that sentence:

> Your committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before your committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period.

I appreciate the opportunity of appearing before the committee.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Bradley. The committee will recess until tomorrow morning at 10 o'clock.

(By direction of the chairman, the following is made a part of the record:)

TREASURY DEPARTMENT,
ASSISTANT SECRETARY,
Washington, D.C., December 4, 1963.

HON. PAUL H. DOUGLAS,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOUGLAS: On October 11, 1963, in response to a request you made, I sent Mrs. Springer several tables which showed the distribution of revenue changes by adjusted gross income class. One of these tables presented figures for the effects of the capital gains provisions. At the request of Senator Long, we have prepared estimates of the distribution of revenue effects for adjusted gross income classes above $50,000. You will recall that the earlier tables gave a single combined figure for all income classes above $50,000.

In the course of preparing these data for Senator Long, we made some refinements in the capital gains estimates. The enclosed table gives our revised figures. You will notice that the revision had the effect of transferring some revenue gains from the middle to the upper income groups. This comes about as a result of a more careful attempt to use the Seltzer 1937 data to distinguish between short-term, class B, and class A gains under H.R. 8363. The class A gains are concentrated in the upper income groups and the revised estimates reflect that fact better than the earlier estimates.

Sincerely yours,

STANLEY S. SURREY.

TABLE 6A.[1]—*Revenue loss and gain from direct and indirect effect of reduction of capital gain inclusion from 50 to 40 percent and reduction of maximum rates from 25 to 21 percent*

	AGI class [In thousands of dollars]									
	0 to 3	3 to 5	5 to 10	10 to 20	20 to 50	50 to 100	100 to 500	500 to 1,000	1,000 and over	Total
	[In millions of dollars]									
Direct effects [2]	−2	−6	−16	−29	−53	−37	−55	−15	−17	−230
Induced effects	+4	+11	+31	+55	+101	+71	+105	+29	+33	+440
Total effects	+2	+5	+15	+26	+48	+34	+50	+14	+16	+210

[1] Supplement to table 6 of the Secretary's Oct. 15, 1963, statement to the Senate Finance Committee. Table 6 appears on p. 152, pt. 1 of the hearings. Table 6A shows the distribution by AGI class of the 1964 revenue effect presented in table 6.

[2] Excluding the effects of indefinite loss carryover (total loss of $30,000,000) and sale of residence by elderly (total loss of $10,000,000).

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Nov. 14, 1963.

STATEMENT OF WILLIAM H. WRIGHT OF PETER KIEWIT SONS CO., OMAHA, NEBR.

MEMORANDUM IN OPPOSITION TO USE OF DECEDENT'S BASIS IN COMPUTING GAIN ON PROPERTY ACQUIRED FROM A DECEDENT

General

The President's 1963 tax message proposed that a capital gains tax be imposed on all net gain accrued on capital assets at the time of transfer at death or by gift. The explanation given by the Secretary of the Treasury for this drastic change from existing law is that—

"Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment choices and frequently results in complete immobility of investments of older persons" (hearings, Committee on Ways and Means, President's 1963 tax message, p. 54; p. 49 of message).

Before the House Ways and Means Committee, this proposal was modified to one requiring that the basis of property acquired from a decedent be that of the decedent, increased by the estate tax on the appreciation. Both of these suggestions are completely unjustifiable and ignore the fact that, when appreciated assets are transferred at death, the appreciation does not escape tax, but is subject to heavy estate taxation—at rates ranging up to 77 percent. To impose an additional capital gains tax on this same appreciation is to resort to double taxation of the most discriminatory type.

Fortunately, some of these considerations were recognized by the House Ways and Means Committee, and the present version of the bill, as passed by the House of Representatives, contains no change in existing law relating to property acquired from a decedent. However, there has been a suggestion that the proposal for a carryover basis will be revived before the Senate Finance Committee. Amendment No. 225 is intended to be proposed by Senator Gore to H.R. 8363. If it is offered, it should be rejected.

The system embodied in present law was adopted advisedly and is not a loophole

There is a laudable effort presently being exerted to close loopholes in the Internal Revenue Code. With this effort no one can quarrel. The difficulty lies in the misinterpretation sometimes put upon the term "loophole." A provision which is fair and which has been adopted advisedly by the Congress, with full knowledge of its workings and effect, is not a loophole, despite the fact that by changing it, additional revenue might be raised. The provision which establishes a date-of-death value (or alternate-valuation date value) for property acquired from a decedent is such a provision.

While there have been relatively minor shifts in congressional policy relating to the proper basis to be accorded property acquired through certain special types of transfer by decedents, there has been no congressional deviation from the principle that, in the normal case, any property owned by a decedent and transferred at death shall take a new basis. While the 1916 and 1918 Revenue Acts contain no specific provision relating to property acquired from a decedent, but had only a general provision that, in the case of property acquired subsequent to March 1, 1913, the basis should be "the cost thereof," Treasury Regulations 45, article 1562, issued under the 1918 act, provided:

"In the case of property acquired by gift, bequest, devise or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto."

These regulations accorded with the intent of Congress, and when a specific provision relating to property acquired by bequest, devise, or inheritance was added to the Revenue Act of 1921, it was noted that "the special rules embodied in existing law with respect to property acquired by bequest, devise, or inheritance are in substance preserved" (H. Rept. 350, 67th Cong., 1st sess., p. 9).

Even at this early date, however, some persons who failed to analyze the relationship between the estate tax and the income tax were suggesting that this rule should be changed. On November 3, 1919, the Secretary of the Treasury submitted to the Ways and Means Committee a document entitled "Notes on the Revenue Act of 1918." This document represented a collection of suggestions for study and was submitted without recommendation by the Secretary, who stated

that the Treasury would be opposed to some of the suggestions contained in it. The document contained the following:

"It has been suggested that, although transfers of property by gift, bequest, devise, or descent should not be treated as giving rise to realized gain or loss, whenever thereafter gain or loss is realized by actual sale, the gain or loss at that time should be measured as the difference between the price received and the cost to the original owner who acquired the property for value.

"It is urged in support of this suggestion that the effect of the present legislation is to permit realized gains due to appreciation taking place during the previous ownership to escape taxation" (pp. 10–11).

With this suggestion before Congress, Dr. T. S. Adams, tax adviser to the Treasury Department, appeared before the Senate Finance Committee in executive hearings on the Revenue Act of 1921. Dr. Adams made two recommendations of interest here. First, he urged that property acquired by gift should take the donor's basis, as suggested in the foregoing notes. Second, contrary to the notes, he urged that property acquired by bequest, devise, or inheritance should take as its basis its fair market value at the date of acquisition. His reasoning was given as follows:

"Senator MCCUMBER. Whatever the child receives by inheritance or bequest it gets without cost or sale exactly the same as a gift. In the next paragraph you make a distinction.

"Dr. ADAMS. That is because the estate or inheritance tax has been imposed. That is the thought behind that" (executive hearings, Senate Finance Committee, Revenue Act of 1921, 67th Cong., 1st sess., p. 27).

And again, Dr. Adams testified:

"* * * Where it is acquired in that way it is subject to estate tax, and I think it is entirely fair and proper. That is the reason we give the value at the time of acquisition. Property acquired by bequest, devise, or inheritance is subject to the estate tax" (p. 198).

Congress accepted both of these recommendations, and section 202(a)(2) of the 1921 act provided a carryover basis in the case of property acquired by gift, while section 202(a)(3) provided that "In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition." It will be noted that there was no gift tax in effect at this time, but that the Federal estate tax dates from 1916.

There were no substantial changes enacted thereafter until 1928. However, in 1926, the Court of Claims decided the *McKinney* case, 62 Ct. Cl. 180, in which it held, under the 1918 act, that a decedent's executor had no "cost" and that the decedent's property in the hands of the executor took the decendent's basis. Congress at once indicated its belief that such a carryover of basis was improper. In the report of the Joint Committee on Internal Revenue Taxation (1927), volume 1, the following statements appear:

"Until recently, gain or loss on executor's sale was measured by the value at the decedent's death of what was sold. As a result of the decision by the Court of Claims in *McKinney* v. *United States*, and the denial of certiorari by the U.S. Supreme Court, the rule was changed so as to provide that gain or loss on such a sale would be measured as though the decedent had sold the property during his life.

"The rule of the *McKinney* case is inconvenient, for it is often impossible to determine the decedent's cost or other basis. Moreover, as a practical matter, it results in taxing the value of bequests, devises, and inheritance as income. The old rule seems preferable, and it is recommended that it be set forth in the statute.

"Section 204(a)(5) prescribes the basis when the beneficiary sells the property as the value at the time of "acquisition." Some doubt has arisen as to what is meant by the date of acquisition. The "date of death" is recommended to make the basis certain and definite (p. 117).

* * * * * * *

"This rule is particularly desirable in view of the difficulty which may be encountered by executors and administrators in ascertaining what the decendent paid for the property, especially when it had been held by him over a long period of time.

"It may be argued that in a substantial sense the rule of the *McKinney* case results in taxing as income the value of property acquired by bequest, devise, or inheritance, a result which is contrary to specific provisions relating to gross income in practically all of the revenue acts. The rule above suggested pre-

serves intact the full force of section 213(b)(3) of the Revenue Act of 1926 and similar parts of preceding acts" (pp. 74–75).

The same position was taken by representatives of the Cleveland Chamber of Commerce, the Association of the Bar of the City of New York, the Committee of Banking Institutions on Taxation, and other witnesses who stressed the impractical, if not impossible, requirement of determining decendent's basis imposed upon the executor by the *McKinney* decision. (See hearings, House Ways and Means Committee, Revenue Act of 1928, 70th Cong., 1st sess.)

As a result of the foregoing report and testimony, the House of Representatives (in the 1928 bill) adopted a provision that date-of-death value was to be the basis of all property acquired by bequest, devise, or inheritance, or by a decedent's estate from a decedent. The latter phrase was intended to overturn the *McKinney* decision. In the Senate Finance Committee, the section was altered to provide two different rules. Date-of-death value was made the basis of property acquired by specific bequest, of real property acquired by general or specific devise, or by intestacy, and of property acquired by a decedent's estate from a decedent. In all other cases, basis was made the fair market value of the property at the time of distribution to the taxpayer.

Thereafter, it became apparent that use of distribution date values permitted a certain amount of tax avoidance by executors who were also testamentary trustees and who could, by judicious selection of the date to effectuate distributions to themselves, control the basis of property in their hands as trustees. A subcommittee of the House Ways and Means Committee recommended that the provision be changed "so that a uniform basis rule may be required in the case of property passing at death, whether real or personal" (hearings, House Ways and Means Committee, Revenue Act of 1934, 73d Cong., 2d sess., p. 136).

Roswell Magill, speaking for the Treasury Department, while questioning certain language changes recommended by the subcommittee, stated:

"* * * I take it that the subcommittee and the Treasury are in agreement as to what the basis should be in those cases. * * *

* * * * * * *

"The Treasury is in entire agreement with your purpose" (p. 145).

Mr. Colin F. Stam, of the staff of the Joint Committee on Internal Revenue Taxation, appearing before the Senate Finance Committee in executive hearings, was most explicit of the then Treasury Department position:

"* * * Under the present law, we use the value at the date of death for computing gain or loss, in most cases, but in the case of property passing as the result of a general or residuary bequest, the present law permits the person receiving the property to take, as the basis, not the value at the date of death, but the value at the date of distribution, which may be a good deal greater than the value at the date of death.

"For instance, when a man dies he may have a piece of property worth $100,000, taking the same illustration. By the time the executor distributes the property, it may be worth $500,000.

* * * * * * *

"* * * The man that receives this property really did not pay anything for it; and *we have gotten the tax up to the date of death through the estate tax*, when the value was $100,000. We have not gotten any tax on the increase in value up to the time of distribution, which was $500,000, and we just want to make it clear that we are going to take as the basis, both for gain or loss purposes, the value at the date of death" (executive hearings, Senate Finance Committee, Revenue Act of 1934, 73d Cong., 2d sess., pp. 65–66). [Emphasis supplied.]

From the enactment of the 1934 act to the present time, property acquired from a decedent has taken a new basis, either its value at the date of decedent's death, or, since 1942, its value on the alternate valuation date, where such alternate has been elected for estate tax purposes. Rather than restricting this well-established principle, in 1954 Congress extended it to cover, for the first time, all property included in a decedent's gross estate for Federal estate tax purposes. This final change clearly indicates a continuing congressional awareness that the Federal estate tax imposed upon appreciated assets eliminates any justification for the imposition of a capital gains tax upon the same appreciation.

The reason given by the Senate Finance Committee for the extension of the date-of-death basis provisions in the 1954 code was simply that, "Under existing law, there is no uniform correlation between section 113(a)(5) and section 811 of the 1939 code, relating to property includible in the decedent's gross estate" (S. Rept. 1622, 83d Cong., 2d sess., p. 423).

It should also be noted that while the concept that all property subjected to the Federal estate tax should take a date-of-death basis was not adopted until the enactment of the 1954 code, the majority report of the Special Tax Study Committee dated November 4, 1947, recommended that "the basis of property acquired by gift but included in the gross estate of the donor should be made the same as it would have been had it actually passed at death, if the property is sold after the donor's death" (hearings, House Ways and Means Committee, 80th Cong., 1st sess., Revenue Revisions, 1947–48, p. 3633).

The foregoing legislative consistence cannot be disregarded, especially in view of the fact that proposals similar to those rejected by the Ways and Means Committee in drafting the present bill, and amendment No. 225 intended to be proposed by Senator Gore to H.R. 8363, have been made periodically ever since the "notes on the Revenue Act of 1918," above referred to. When Congress was confronted with the emergency of the Nation's participation in World War II, Randolph Paul, Tax Adviser to the Secretary of the Treasury, stated to the Ways and Means Committee:

"Under present provisions the basis for determining gain on an asset acquired from a decedent is the market value of such asset at the date of death. Appreciation in value in the hands of a decedent thus becomes frozen in the basis accorded to the heir or legatee.

"A large part of the capital gains inherent in the increased value of property thus escapes income tax, as the assets are handed down from one generation to the other. To remove this special privilege, it is suggested that the basis of property to the recipient for the computation of captial gains and losses be the same as it was in the hands of the decedent" (hearings, House Way and Means Committee, 77th Cong., 2d sess., Revenue Act of 1942, pp. 89–90).

Despite the fact that this constituted a Treasury Department proposal, and despite the need for substantially increased revenues to support the war effort, the Ways and Means Committee wisely included no such provision in the bill reported by it to the House of Representatives and no such provision was in the bill passed by that body and sent to the Senate. The recommendation was not renewed before the Senate Finance Committee.

Thus, the principle that appreciated assets should be given a basis equal to the estate tax paid valuation in the hands of the person who has acquired them from a decedent is the result of considered congressional judgment over the past 42 years. Furthermore, such judgment has been exercised in the face of repeated arguments that such appreciation had "escaped income taxation." Such an established legislative policy should not now be reversed in the absence of compelling reasons to do so. Such reasons do not exist. Rather, the reasons which have traditionally supported the present law are equally valid today.

A carryover basis is no more than a disguised drastic estate tax increase, applied unequally to estates of equal size

The impact of Federal estate taxation, with rates ranging up to 77 percent, is completely disregarded by the proponents of the carryover basis. Yet for anyone seriously concerned about "incentives" to encourage the flow of wealth into productive enterprises, the Federal estate tax stands as a serious obstacle. One of the prime motivating forces in American life is the desire on the part of taxpayers to enhance their wealth for the benefit of ensuing generations of their family. To the extent that the Federal estate tax renders this more difficult, this motivating drive to invest, to furnish risk capital in the hope of reaping a substantial gain, is lessened. Nevertheless, for policy reasons long accepted by Congress, the estate tax is a part of the American scene and it is not here suggested that it be repealed or the rates thereof reduced.

However, it must be recognized that the present proposal to establish a carryover basis in the case of property acquired from a decedent is, in reality, a disguished increase in estate tax rates. Furthermore, it is an increase which affects only those estates the creator of which has most successfully invested his capital to produce an enhancement in his, and the Nation's, overall wealth. The enactment of the proposed amendment would place a premium upon liquidity, upon investments in safe, but nongrowth assets, such as bonds and insurance. This is not to say that such investments are unwise, or that they do not furnish capital for the growth of the Nation's business; it is to point out that such investments are a far cry from true risk capital.

Validity of the foregoing criticisms may be demonstrated by a comparison of four situations, each involving an estate of precisely the same size.

Case 1

Assume:

Taxable estate comprised entirely of life insurance and bonds with a market value of par	$5,060,000
Federal estate tax	2,468,200
Balance remaining after payment of taxes	2,591,800

This is the result under present law, it would be the result if a carryover basis provision were enacted into law.

Case 2

Taxable estate comprised entirely of stock with a basis of $506,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (4554/5060×2,468,200)	2,221,380
Add basis of stock	506,000
New basis of stock	2,727,380
Ratio of basis to value of stock	53.9
Ratio of gain to value of stock	46.1

If stock with a market value of $2,500,000 is sold to raise funds to pay the estate tax:

Capital gain (0.461×$2,500,000)	$1,152,500
Capital gain tax at 21 percent	242,025
Add estate tax	2,468,200
Cash need	2,710,225

There is thus an additional cash requirement of $210,225. If an additional $235,000 of stock is sold:

Capital gain (0.461×$235,000)	$108,335
Capital gain tax at 21 percent	22,750
Total selling price	235,000
Less capital gain tax	22,750
Additional cash raised	212,250
Federal estate tax	2,468,200
Add capital gain tax on initial sale	242,025
Add capital gain tax on second sale	22,750
Total taxes	2,732,975
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,732,975
Balance remaining after payment of taxes	2,327,025

Thus, due to the need to sell appreciated assets to pay Federal estate tax, total taxes are increased $264,775, or 10.73 percent. The value of the assets remaining after payment of taxes is reduced 10.22 percent, and such assets have a basis of only 53.9 percent of their value, so that a substantial additional capital gain tax will become due if they are sold in the future.

Case 3

Taxable estate comprised of $1,000,000 insurance, $1,000,000 bonds valued at par, and stock with a basis of $306,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (2754/5060×$2,468,200)	1,343,343
Add basis of stock	306,000
New basis of stock	1,649,343
Ratio of basis to value of stock	53.9
Ratio of gain to value of stock	46.1

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If stock with a market value of $500,000 is sold, with insurance and bonds, to pay estate tax:

Capital gain (0.461×$500,000)	$230,500
Capital gain tax at 21 percent	48,405
Add estate tax	2,468,200
Cash need	2,516,605

There is thus an additional cash requirement of $16,605. If an additional $20,000 of stock is sold:

Capital gain (0.461×$20,000)	$9,220
Capital gain tax at 21 percent	1,936
Total selling price	20,000
Less capital gain tax	1,936
Additional cash raised	18,064
Federal estate tax	2,468,200
Add capital gain tax on initial sale	48,405
Add capital gain tax on second sale	1,936
Total taxes	2,518,541
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,518,541
Balance remaining after payment of taxes	2,541,459

In this case, by use of the nonappreciated assets to pay the bulk of the Federal estate tax, total taxes are increased only $50,341, or 2.02 percent, but the previously well-balanced estate is now entirely in stock. The stock, of course, has a basis of only 53.9 percent of its value, as in case 2.

Case 4

Taxable estate comprised entirely of stock with a basis of $506,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (4554/5060×$2,468,200)	2,221,380
Add basis of stock	506,000
New basis of stock	2,727,380
Ratio of basis to value of stock	53.9
Ratio of gain to value of stock	46.1

If, for business reasons it is necessary or desirable to sell all of the stock:

Capital gain (0.461×$5,060,000)	$2,332,660
Capital gain tax at 21 percent	489,859
Federal estate tax	2,468,200
Add capital gain tax	489,859
Total taxes	2,958,059
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,958,059
Balance remaining after payment of taxes	2,101,941

Here total taxes are increased $489,859, or 19.85 percent, an utterly unjustifiable increase, and total taxes are very much greater than would have been the case had the stock been sold immediately prior to death.

Capital gain ($5,060,000 less $506,000)	$4,554,000
Tax on gain at 21 percent	956,340
Taxable estate ($5,060,000 less $956,340)	4,103,660
Estate tax	1,863,400
Add capital gain tax	956,340
Total taxes	2,822,045
Total taxes if stock sold after death	2,958,059
Total taxes if stock sold before death	2,822,045
Difference	136,014

Orderly administration of estates will be seriously jeopardized by carryover basis

It is axiomatic that one of the first duties of a fiduciary administering the estate of a decedent is to plan to meet the necessary cash requirements. Under present law, this requires the fiduciary to ascertain the approximate date-of-death value of the decedent's estate. Using this figure as a guide, a relatively close approximation of administration expenses and death taxes can be made in a comparatively short time following the decedent's death. Debts can be ascertained, and, thus, cash requirements estimated. The prudent fiduciary begins at this point to raise the necessary cash. To wait until the alternate valuation date for the Federal estate tax has passed, or until the cash must actually be spent, is to gamble with trust funds. A serious decline in market values, leaving the fiduciary compelled to sell an excessive percentage of the decedent's estate might well subject the fiduciary to surcharge.

Now, however, assume that all assets formerly belonging to the decedent are held by the fiduciary with the decedent's basis, or with such basis increased by the amount of Federal estate tax attributable to any appreciation in value. In either case, before sales can be prudently made for the purpose of raising cash needs, a determination of the decedent's basis for every asset must be made. Since the immediate sale of highly appreciated assets will greatly increase the estate's tax burden, as discussed above, good judgment requires that, where possible, those assets which have appreciated least be sold first. This fact produces two extremely undesirable results.

First, the desire to avoid incurring additional taxes may lead the fiduciary to sell the more stable, safer investments, and to retain the more speculative, those which have increased in value the most in the past, but which may decline the most in the event of a market decline. The sale of such stable assets, if there is a decline in remaining volatile assets, will assuredly be the subject of criticism, if not actual attack, by the beneficiaries of the estate. On the other hand, if the speculative assets are sold, and the stable investments retained, and there is no market decline, the unfortunate fiduciary is wrong again. He has incurred unnecessary tax expense, and the beneficiaries of the estate are equally disturbed.

Second, before any consideration can be given to which assets are to be sold, the basis of all assets in the estate must be known. Yet, where the assets have been acquired many years before, or have passed through several estates, always with a carryover basis (as would be the case in the future, if not in the first few years under the proposed new law), such determination will be extremely difficult, if not impossible. At the very least it will require a good deal of research by the fiduciary; research takes time. Until such time has been spent, sales will not be made, and the fiduciary will be unavoidably delayed in his imperative task of providing for the cash needs of the estate. Orderly estate administration will have been sacrificed on the altar of Federal taxation.

A carryover basis poses serious problems for estate beneficiaries

If specific assets acquired from a decedent are required to take as their basis the basis in the hands of the decedent, serious inequities can result among the beneficiaries of an estate. For example, if a father has two children, one daughter and one son, whom he desires to treat equally, he may find it impossible to do so. Assume a $2 million estate after payment of taxes, one-half consisting of stock in a closely held corporation in which the son is an active participant, one-half in bonds. Assume further that the stock has a basis of $200,000 and

the bonds a basis of $1 million. Under present law, equal treatment of son and daughter is a simple matter of leaving the stock to the son, the bonds to the daughter. The son is given the business interest which he desires, the daughter is given a readily marketable security. However, if the son were to take the stock with a $200,000 basis, or even with a $200,000 basis increased by the estate tax on $1,800,000 of appreciation, he would receive an asset substantially less in realizable value than the daughter whose bonds would have no appreciation subject to tax on disposition.

On the other hand, if the stock and the bonds were each to receive a basis of $600,000 (one-half of the aggregate basis of the stock and the bonds), so that each asset was considered to contain potential capital gain of $400,000, the daughter would be seriously wronged. She would acquire $1 million of bonds which had cost her father $1 million. Such bonds would in no true sense whatsoever have any capital appreciation inherent in them. Yet, upon their sale, a completely fictitious gain of $400,000 would be taxed to the daughter, although the decedent could have sold without gain. There is no constitutional justification for such a tax, which would surely be a capital levy. It would be as just and as constitutional to enact a statute providing that all assets acquired at death take a basis of zero, or $10, or $1,000, regardless of their cost to the decedent, as to arbitrarily reduce the basis of the bonds from $1 million to $600,000, and to transfer a portion of the bonds' cost to the stock, thereby increasing its basis from $200,000 to $600,000.

Under the proposal appreciation would be taxed higher in small estates than in large estates

Under a basis carryover provision which has been proposed, the same dollar amount of appreciation would bear a higher capital gain tax after passing through an estate of moderate size than it would after passing through a larger estate.

Assume three estates, each including a stock with a basis of $100,000 and appreciation of $900,000, with a date of death value of $1 million, with respective taxable estates of: A. $1 million; B. $5 million; C. $10 million. The stock in question is sold by the executor or heir.

A

Taxable estate		$1,000,000.00
Estate tax		303,500.00
Portion of estate tax attributable to appreciation (9/10×303,500)		273,150.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	273,150	
		373,150.00
Capital gain		626,850.00
Tax thereon at 21 percent		131,638.50

B

Taxable estate		5,000,000.00
Estate tax		2,430,400.00
Portion of estate tax attributable to appreciation (9/50×2,430,400)		437,472.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	437,472	
		537,472.00
Capital gain		462,528.00
Tax thereon at 21 percent		97,130.88

C

Taxable estate		$10,000,000.00
Estate tax		6,042,600.00
Portion of estate tax attributable to appreciation (9/100×6,042,600)		543,834.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	543,834	
		643,834.00
Capital gain		356,166.00
Tax thereon at 21 percent		74,794.86

In many instances the effect of carryover basis could be avoided by the astute

One of the primary and most substantial criticisms leveled at the present Internal Revenue Code is that its complexity and, to be frank, its frequent departures from what might be termed "commonsense law," render it a trap for the unwary, while its more rigorous provisions can be avoided by those with astute tax counsel. So it is with the carryover basis provision.

Unless an average basis device is employed, a law requiring property acquired from a decedent to take the decedent's basis would work further hardships on some taxpayers while posing relatively little problem for others. For example, it would be a simple matter for a decedent possessing both appreciated and nonappreciated property to provide by will that the former pass to taxpayers in low tax brackets, while giving the latter to those in higher brackets. If a charitable bequest were involved, the appreciated property could be left to charity and the nonappreciated to the family. It would not even be necessary to specify the property to go to charity, if a general clause required satisfaction of the charitable bequest with the most appreciated assets. The tax results in such case would be the same as under present law. If the appreciated assets consisted of securities with a widespread market, and if the family felt that they would prefer to hold such securities rather than the assets left to them, they could sell their bequests of nonappreciated assets with relatively little capital gain and reinvest the proceeds in an open-market purchase of assets comparable to those left to the charity. Where such careful tax planning was not performed, however, the results for the family could be entirely different.

CONCLUSION

It is submitted that the proposal for a carryover basis in the case of assets acquired from a decedent ignores the long legislative history of the present law, is unworkable and unjust, and adds a completely unnecessary complication to the Internal Revenue Code. Unrealized appreciation is not free of tax so long as the Federal estate tax contains rates ranging as high as 77 percent, and no present proposal exists to reduce such rates. The suggested legislation, to the contrary, is a disguised attempt to raise such tax rates in a discriminatory and unwise fashion. Appreciation over several generations would be subject to tax in the hands of the last owner, thereby subjecting him to the cumulative impact of inflation and a tax penalty which might make prohibitive a wise decision to dispose of the property. The imposition of a tax such as will result from the carryover basis proposal does far more than plug a nonexistent "loophole." It would distort income, penalize growth, and discriminate among taxpayers. It should be defeated.

STATEMENT OF RALPH R. BORCHARD, CHAIRMAN, REALTORS' WASHINGTON COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS

Mr. Chairman and members of the committee, I appreciate this opportunity to present this statement containing the recommendations of the National Association of Real Estate Boards with respect to the pending measure. The views expressed herein are based on the actions taken by our recent annual convention in New York, November 10–14, 1963. Where appropriate I will include as part of these remarks the pertinent excerpt of our policy statement.

TAX REDUCTION

Our association strongly urges that the committee act favorably upon the measure so that the reductions in individual and corporate rates might become effective at the earliest possible date. Our convention expressed itself on the matter of rate reduction in these words:

"The present high individual and corporate income tax rates are preventing the economy from achieving a maximum level of investment and production. We urge Congress to enact necessary legislation to reduce individual and corporate taxes, and to work toward reductions in Government spending to combat inflation and aggravated deficits."

Our support of early tax reduction through approval of the pending measure does not mean that we are unconcerned over the serious deficits that will occur during the current and probably the next 3 fiscal years. However, we sincerely believe that making available an additional $11 billion to the spending and investing public will provide a stimulant to the economy—a stimulant which is essential to achieving a greater level of growth.

At the same time we are concerned over the growth of nondefense spending. However, we believe that the Congress, in approving the pending tax bill, will exercise maximum restraint during the next session of the Congress in the adoption of any new programs to cope with problems which are inherently local.

The remainder of our statement refers to specific sections of the bill, H.R. 8363, concerning which we are making recommendations. These will be discussed in their proper order.

SECTION 212. MOVING EXPENSES

The bill provides a new moving expense deduction which will be available under certain conditions to all employees, whether newly hired or transferred, whose expenses are not excluded from income under present law. Under present law such deductions are excluded only in the case of existing employees.

While this provision has considerable merit and we recommend its approval, we believe that it does not meet the great inequity which affects adversely thousands of employees who must sell their homes in order to move to other locations. The labor force is becoming increasingly mobile and anything which inhibits mobility tends to defeat the national full employment objective.

Many employees are forced to put their homes on the market for quick sale, and as a result often sustain a loss because of their inability to wait a reasonable time to obtain the fair market or appraised value. Employers recognize this by reimbursing the employee the difference between the appraised value and the actual sales price. Under existing law this reimbursement is considered taxable income to the employee.

Our recent annual convention recognized this inequity by adopting a resolution as follows:

"We recommend legislation to provide that reimbursement by an employer to a transferred employee of the difference between the appraised value and the net proceeds from the sale of his home be considered as part of the sales price and not as taxable income to the employee."

We suggest an amendment to H.R. 8363 that such reimbursement amounts (difference between the sales price and fair market value as determined by an independent appraisal) be treated as part of the amount realized by the employee on the sale of his residence and not be regarded as additional compensation.

In order to provide uniformity and certainty of administration and to prevent abuse, the following requirements should be specified:

(1) The employee receiving reimbursement must otherwise qualify for the moving expense exclusion under proposed section 120.

(2) The fair market value of the employee's house must be established by the averaging of two or more appraisals made by qualified and independent real estate appraisers selected by the employer.

(3) The employee must actually sell his home within 1 year of commencing work at his new duty station. This period provides flexibility in that the employee frequently starts work at his new job location several months before his wife and family join him because of school problems for the children, etc. On the other hand, the 1 year cutoff tied to the employee's commencement of

work at the new duty area provides certainty and at the same time bars an open end arrangement which might be regarded as getting far afield from a forced sale.

(4) To take account of objections informally raised by the Treasury regarding possibilities of abuse in the case of corporate officers or stockholders, the benefits proposed should be limited in the case of corporate officers or 10-percent shareholders to not more than 15 percent of the gross selling price of the home.

SECTION 216. PERSONAL HOLDING COMPANIES

The objective of the personal holding company provisions has never been, and should not be, to penalize an active trade or business which is conducted in the corporate form for bona fide business reasons. For more than 25 years rentals have been excluded from personal holding company income if they constituted more than 50 percent of a corporation's gross income. In its proposed changes in existing law the bill substantially penalizes and discriminates against active rental businesses of closely held corporations by treating all rents received (even though the 50-percent test is more than met) as personal holding company income if more than 10-percent of the corporation's total income consists of dividends, interest, or other passive-type income. This is done with respect to no other active business operation. The proposed new 10-percent rule prevents the earning even of a reasonable return upon reserves which must be maintained for capital replacements and betterments, unusual maintenance and repairs, local improvement assessments, and contingencies.

The bill also substantially penalizes and discriminates against active rental business by introducing a "net rental" concept into the determination of whether the rentals of a closely held active rental business corporation amount to 50-percent of its gross income. There may be some justification in requiring the subtraction of interest and rent paid from gross rentals—in view of the fact that the principal concern of the Treasury Department was the ownership of rental real estate with an insignificant equity and a maximum amount of mortgage. There is no justification, however, in logic or otherwise, in also requiring the subtraction of depreciation and taxes, since these are expenses normally incident to any business operation, and are largely independent of the taxpayer's control.

We urge the elimination of these discriminatory provisions.

SECTION 219. CAPITAL GAINS

We recommend retention of the provision in the present bill reducing the capital gains tax on certain capital assets, including real estate, held by individuals for more than 2 years, to a maximum rate of 21 percent (instead of the present 25 percent) computed by reducing from 50 to 40 percent the proportion of capital gain included in the taxpayer's ordinary income.

SECTION 220. DEPRECIABLE REAL ESTATE

Recapture formula

H.R. 8363 provides that where realty is disposed of during the first year following acquisition or completion of construction, all of the gain to the extent of the depreciation taken is taxable at ordinary income tax rates. Where the holding period is in excess of 1 year but less than 21 months, all of the gain to the extent of the depreciation taken in excess of straight line would be taxed at ordinary rates. Beginning with the 21st month, the percentage of this "excess" depreciation recaptured as ordinary income would be reduced 1 percent per month. Thus the taxpayer whose property has been subject to accelerated forms of depreciation would not realize complete capital gains treatment until after the property has been held for 10 years.

While we endorse the approach of the House of Representatives to the problem of abuse in the use of accelerated depreciation coupled with quick turnover, we nevertheless believe that the formula in H.R. 8363 is excessively harsh. Certainly a shorter holding period, such as 6 years, would prevent the abuses which have been attributable to the quick turnover of property. In order to achieve a 6-year holding period we recommend that section 220 be amended so that beginning with the 22d month of holding period the percentage of gain taxable at ordinary income rates (gain to the extent of depreciation taken in excess of straight line) be reduced 2 percent per month instead of 1 percent.

Application of formula to leaseholds

Under section 178(a)(1), if the remaining term of the original lease is less than 60 percent of the remaining life of the building, any renewal period is to be included in determining the life of the building. If the remaining term is more than 60 percent a renewal period may not be included and the value thereof must be amortized over the remaining term. For example, if the remaining term of the original lease was 30 years with a renewal period of 30 years and the life of the building 40 years, no renewal period would be taken into account since 60 percent of 40 (the remaining life) or 24 does not exceed 30 (the remaining term of the lease). Therefore the value of the building must be amortized over the 30-year term, in lieu of any depreciation under section 127(b), and the deduction would be equal to 3.3 percent.

On the other hand, if the remaining term of the original lease was 20 years with a 30-year renewal period and with a 40-year remaining life of the building, the renewal period would be included under section 178 and the value of the building could be depreciated over the period of 40 years, with the use of the double declining balance method of depreciation, which would result in a deduction equal to 5 percent for the first year.

Under section 1250, any renewal period must be taken into account in determining additional depreciation, up to two-thirds of the original lease period. This produces an inequitable result in that for purposes of section 178 the taxpayer is denied the right to include a renewal period in determining amortization or depreciation with respect to any year, whereas for purposes of section 1250, the taxpayer is required to include any renewal period. This inequitable result could be eliminated by amending section 178 to give the taxpayer an option to include a renewal period, even though not required under the 60-percent test.

These same considerations apply to the amortization or depreciation of the costs of acquiring a lease under section 178(a)(2) whereby the renewal period is to be excluded if more than 75 percent of such cost is attributable to the remaining term of the lease. Should the recommended change be adopted, the tenant should also be allowed a similar election to include the renewal period in determining the amount allowable for depreciation or amortization under this section.

Treatment of accelerated depreciation on used property (150 percent declining balance method)

We are very pleased that the House report clearly recognizes that under existing law the 150-percent declining balance method of depreciation is available for any real property which does not qualify for the special accelerated methods of depreciation provided by paragraphs (2), (3), and (4) of section 167(b) of the Internal Revenue Code of 1954. The right to use the 150-percent declining balance method of depreciation for used real property, as now provided under existing law, is very important to the real estate industry. We respectfully request that the committee make no change in the existing law which permits the use of this method of depreciation.

Application to sale of partnership interest

The new provision is particularly harsh in the case of a sale by a partner of an interest in a partnership which owns real property. Even though the real property may be held by the partnership for long-term investment, so that there is no sale of the real property within the 10-year period, a partner would be treated under the proposed provisions as having ordinary income upon the sale of his interest in the partnership to the extent of the portion allocable to him of the depreciation which would be treated as ordinary income if the property was sold. This is a particularly harsh result since the depreciation which causes ordinary income to the selling partner is not adjusted by reason of the sale, and can continue to cause ordinary income to result in the case of other sales of interests in the same partnership, so that the same depreciation amount is taken into account over and over again.

Furthermore, this provision works with particular hardship on small partnerships when they are dissolved, either by mutual agreement or by death. For example, assume that two brothers have a partnership which owns two parcels of improved real estate, Blackacre and Whiteacre, and in the case of each property they have depreciation which would cause ordinary taxation under section 1250 if the property was sold. If the brothers terminate the

partnership by one brother taking Blackacre and the other brother taking Whiteacre, the proposed provisions would impose a tax at ordinary income rates upon each brother to the extent of the additional depreciation as to each property. This would be true even though neither brother plans to sell the property he receives, and even though each must use his partnership basis for the property he receives.

We urge the committee to change the proposed provisions so that they are not applicable either to the sale by a partner of his partnership interest or to a distribution in kind of the property to a partner, whether or not the distribution is pro rata to all partners. If the committee, after careful examination, should feel that some provision must be inserted with respect to the sale of a partnership interest, then we would urge that in such case there should be an appropriate adjustment to the potential section 1250 gain of the partnership which caused the ordinary income result on the sale. However, we would like to reiterate that in no event do we think that section 1250 gain should be taxed where there is a distribution in kind of real property to a partner, particularly in the case of a distribution in termination of the partnership interest.

Tax benefit rule

The entire reason stated for section 1250 by the administration in proposing it to the Congress is that accelerated depreciation, when coupled with a quick sale of the property, permits a tax benefit through obtaining depreciation deductions against ordinary income, and a capital gain on sale. There will nevertheless be cases where the taxpayer will have taken depreciation deductions which do not yield a tax benefit to him, but which reduce basis so as to require a taxable gain on the sale. We recognize that a taxpayer may have difficulty in establishing when he has received no tax benefit from his depreciation deduction. Nevertheless, we feel that he should be permitted to do so in order to avoid the ordinary income tax imposed by section 1250. It is difficult enough for a taxpayer to have to pay capital gain upon the sale of property, where that gain results from depreciation deductions which have not benefited the taxpayer. There is no reason in such a case to increase the burden by making the taxpayer pay an ordinary income tax on the gain resulting from depreciation deductions which produced no tax benefit. Indeed, such a situation could lead to increased litigation by giving revenue agents an incentive to attempt to change the depreciation deductions of taxpayers who have had losses in prior years, so as to increase the amount of their ordinary income on the sale of the property without giving them any benefit for the increased deductions in prior years.

In view of this situation, it is respectfully urged that the committee provide that a taxpayer may have the opportunity to show that his depreciation deductions did not produce a tax benefit, and thereby to reduce or eliminate the amount of gain which is subject to ordinary income tax under section 1250.

SECTION 223. CONTROLLED GROUP OF CORPORATIONS

The bill imposes a penalty tax on the taxable income of affiliated corporations that do not file consolidated returns and elect to retain multiple surtax exemptions. The additional penalty is 6 percent on the first $25,000 of income.

The penalty is unduly onerous. The Treasury Department has the authority to disallow the multiple surtax exemption in the case of any of a group of affiliated corporations whose election to do business as a corporation is motivated by tax purposes and is not for a bona fide business purpose.

In the real estate industry it is a bona fide business purpose for individuals to do business as mortgage bankers (the Federal Housing Administration requires that its approved mortgagees do business in the corporate form), management firms, brokerage, development, and homebuilding. Each of these involves a bona fide business purpose wherein the separate corporate form is dictated by law, Government regulation, or business prudence, or any combination of these. A development firm, or a corporation engaged in homebuilding, management, brokerage, or mortgage banking, would be placed in an unfair competitive position if it were to be taxed at the 28-percent rate on the first $25,000 of income instead of the regular 22 percent, as provided in the new corporate rates.

We strongly urge that the committee reject this provision in H.R. 8363 and leave with the Treasury its present effective regulations to disallow the multiple

surtax exemption in the case of affiliated corporations whose decision to do business in the corporate form is dictated by tax purposes or by other than a bona fide business purpose.

We commend these recommendations to the sympathetic consideration of the committee. The staff of the Realtors' Washington Committee, including our tax counsel, is available to cooperate with the staff of the Joint Congressional Committee on Internal Revenue and the Senate Finance Committee in the preparation of any memorandums or submission of additional information covering these recommmendations.

THE COMMONWEALTH OF MASSACHUSETTS,
DEPARTMENT OF ECONOMICS, UNIVERSITY OF MASSACHUSETTS,
Amherst, November 21, 1963.

Senator BYRD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I note that you are chairing the committee that is conducting hearings on the tax cut bill as it is called. Much testimony has been collected on this problem of the so-called tax cut legislation from very able economists and reported in hearings before the Joint Economic Committee of the Congress. Additional information has been provided through the daily papers and I would like to add my comments as an economist for the consideration of your committee.

Briefly I support, in essence, the position of Professor Smith of the Harvard Business School that now is not the time for a tax cut when the economy is functioning at a high level. I am in favor of the reform intended by the bill which is to reduce the rate of progression on high incomes, remove the possibility of indiscriminate deduction for business expenses and lower the corporate income tax. I accept all the reasons offered by others and would like to add or emphasize one growing out of my own research. This reason is that I believe the unemployment figures for the United States under present conditions are usually interpreted to indicate greater unemployment hardship than actually exists.

As background for my statement, I would like to quote from Mr. Martin Gainsbrugh, vice president of the National Industrial Conference Board who said before a subcommittee of the Joint Economic Committee of the Congress as follows:

"* * * The rate of unemployment is affected by the degree of option a worker can exercise in choosing to remain unemployed rather than to continue to work at unsatisfactory rates of pay or hours. 'From this point of view,' the Bureau of Labor Statistics observes, 'the relatively high wages of American workers facilitate voluntary job changes that may involve a period of unemployment, and permit laid-off workers to hold out for jobs in which they can use acquired skills and maintain their customary wage. The unemployed European worker, whose hourly wage when employed is perhaps one-third to one-fourth that of the American may be pressed to find a job relatively soon, even if it means abandoning his trade and taking a cut in pay.' The Japanese worker often cannot afford to remain unemployed and accordingly continues to lower the supply price for labor until the market is cleared * * *.

"* * * With high and increasing levels of wages and unemployment insurance come greater options on the part of the displaced worker as to the terms of his reemployment * * *."

My research is pertinent to this because it shows that in the North Adams area in Massachusetts in August of 1962 of those people who had exhausted their unemployment benefits and extended benefits between January 1, 1960, and June 30, 1962, 43.3 percent had found other jobs, 28.2 percent had removed themselves from the labor force, and only 18.5 percent were seeking work. Of this 18.5 percent seeking work, it is probable that some of them were overage, some unemployable for physical and psychic reasons, and some were seeking only part-time work. The total number of persons in the sample was 1,410 of whom 724 were male and 686 were female. Of this number, 663 were interviewed or returned questionnaires that were usable. Careful check was made from day to day and the percentages did not vary a great deal, so that if 100 percent had been interviewed the percentages would not have been much

different. The division of employment security in Massachusetts was unable to publish this study because a bureau in Washington said that it did not follow their format and that they would never have had authorized the study in the first place. This is remarkable in view of the testimony presented before the aforementioned committee and recorded in Public Document 20402 called Measuring Employment and Unemployment.

The evidence from North Adams which was so conclusive for the area because of the size of the sample is confirmed by other studies in Massachusetts involving smaller sample taken by other people at different times. It does not say anything about the miners of West Virginia who may be facing a different kind of situation but does say that unemployment data tends to exaggerate the situation and that some unemployment is due to unemployment insurance and high wages.

Sincerely,

PHILIP L. GAMBLE,
Head, Department of Economics.

NEW YORK, N.Y., *November 29, 1963.*

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I appeal to you honorable gentlemen of the Senate Finance Committee of the 88th Congress please act favorably on H.R. 1787 which is a tax proposal. This proposal was introduced through my suggestion by my Congressman, Leonard Farbstein of the 19th Congressional District in New York. This proposal, H.R. 1787, would give a tax relief equal to the yearly minimum amount of social security benefits to those sons and daughters who are now supporting an aged parent who has no social security coverage or another retirement income on their old age. My reason for asking for such a tax relief is that under the present Federal income tax law, social security is not considered as income, and any aged parent who is receiving social security benefits can still be claimed as a dependent. There is no provision in the Federal income tax law that gives any consideration to those sons and daughters like myself who are now supporting an aged parent who has no social security coverage or another retirement income on their old age. I therefore appeal to you U.S. Senators, members of the Senate Finance Committee of the 88th Congress, please act favorably on H.R. 1787 which is a tax proposal.

I hope and trust that my appeal to you members of the Senate Finance Committee will not receive a deaf ear since every member of this elected committee have received a letter from me and material about those unfortunate aged citizens who have no social security coverage or another retirement income on their old age but are strictly supported by a son or daughter. I wish to inform this committee that I testified before the Committee on Ways and Means of the 88th Congress on February 20, 1963, and I appealed to the Congressmen on this committee to act favorably on H.R. 1787 and I was given a deaf ear. Please don't let my appeal to you honorable gentlemen of the Senate Finance Committee of the 88th Congress go unanswered but act favorably on H.R. 1787 which means so much to those sons and daughters who are now supporting an aged parent who has no social security coverage or another retirement income on their old age. I'm quite sure each and every one of you U.S. Senators who are members of the Senate Finance Committee have constituents in the States you represent who have no social security coverage or another retirement income on their old age. Please keep those unfortunate aged constituents in mind since they helped in electing you honorable gentlemen to represent them in the U.S. Senate and they have given you a public trust. I urge you members of the Senate Finance Committee of the 88th Congress please act favorably on H.R. 1787 since it would give a tax relief to those sons and daughters who are now supporting an aged parent who has no social security coverage or another retirement income on their old age.

Sincerely yours,

HERMAN ROSANETZ.

Statement of Frank K. Jones, Executive Consultant, Berwyn, Pa., Re H.R. 8363 and the Federal Tax Law Revision in General

PERMANENT TAX STUDY COMMISSION

In my opinion there can be no lasting solution to the tax problem until the Congress establishes a Commission under the Treasury Department or the Internal Revenue Service instructed to conduct continuing studies—a place where all groups can go to express opinions. Such studies should be made throughout the Nation and not restricted to Washington, since this would preclude the "man on the street" being able to participate. Such a "forum" was conducted in various places to acquaint business with the more recent tax legislation—the Pennsylvania State University sponsored it in Philadelphia. It was self-supporting as to expense, and very fine as to result. I endeavored to interest them in continuing along the lines mentioned above.

I also endeavored over the past few years, and more energetically from the time the current 1963 tax revisions were announced in the press, to get the press and some of the chambers of commerce interested in tax study forums. I succeeded in sitting down with the executive committees of some of them, and editors discussed the thing with me, but "it was not an issue" at the time so nothing developed. However, let me enter the following editorial into the record (from the Philadelphia Bulletin) of about October 11.

"A Permanent Tax Commission

"The Committee on Federal Tax Policy, a private, nonpartisan group of tax experts, has recommended that a permanent commission, representing business and professional men, Congress and the public, be established to make a continuing study of Federal tax reform, review all proposed legislation and make recommendations to Congress.

"The idea has merit.

"Too often, tax revision and reform are tackled in fits and starts, a bill is drawn up after a flurry of intensive activity and study, and then the lobbyists go to work and tear it apart.

"It certainly seems the Federal tax policy is important enough to the economy to warrant continuing study and review. A continuing commission could also serve as a buffer between Congress and the special interest groups and their lobbyists, thus taking some of the pressures off of Congressmen.

"Such an independent commission, of course, would be subject to the same pressures which work upon Congressmen, but would be expected to be less responsive to them.

"The tax commission idea has been used to advantage in some other nations. What has been good for them might also be good for us."

If such a commission should now come into being, it must, of necessity, provide for small independent business and the "man on the street" to be on that commission, so that his problems can be properly treated.

If this is not done, then it will amount to the same thing as the "national morality" theme which is brought up from time to time by Secretary Hodges, The Ford Foundation and Look magazine, etc. The issue is made, but no followup, even though interest is aroused—so you just create apathy; the thing they all decry.

It is apparent that the population explosion and the modern technological breakthrough has created a very much expanded segment of our citizenry which has arrived and who are pushing and shoving for their "place in the picture." It is just as apparent that this explosion upset the previous balance of the economic structure and disturbed a section of the society which could not benefit as much from the new order, but did not intend to be left behind. So the gap between that combined portion and the unskilled portion widens. The first set launches the inflationary wave and try to keep up with it; the latter section can do nothing to help itself.

There is no quarrel with the proper and orderly improvement of one's status. But is it right to expect this to be suddenly accomplished at public bonded indebtedness for their children, and yours and mine to try to pay off? I think not; we are trying to grow too big entirely too fast, without the desire or intention to pay the cost currently.

PURPOSES

It is my general endeavor to stress the plight of the lower bracket taxpayer and more particularly the small, grassroots businessman as we used to know small business, and thus improve the purchasing public. Today "small" is a relative term when considered from the standpoint of today's "bigness," but a dollar becomes increasingly more significant to the small businessman as the gap between smallness and bigness increases.

These small segments of our economy are the customers of the larger segments and keeping that soil of the economy fertile is the surest way of making a stable economy over the long run.

It is questionable if a tax cut alone is desirable at this particular time. It is also rather questionable if Government spending is going to decrease, regardless of the party in power (and this has been the pattern for several administrations in succession). What is more to the point, that we should direct our efforts to those who come to the Federal Government asking for Government spending and not being particular as to how much is being spent just so long as they get it. And if I remember correctly enterprises of that type even indulged in admitted rigging of bids on Government work. I also question the sincerity of some sections of our economy, at least, who claim that taxes are chasing business away. I refer to the contention of the railroads when they come to the Congress for removal of excise taxes because these taxes were chasing customers, and then promptly filed for an increase in rates of exactly the same amount—the net result to the rider was just the same.

There are a few basic thoughts which seem to have been lost track of, and I would like to bring them to your attention.

1. Most people are not half as bothered about taxes themselves as they are of having the tax money thrown away—and that goes right to those who are on the receiving end, scrambling for more than they should, spending, travel and building, and research money on commercial projects out of public defense moneys (and I don't place this blame on the Congress but on the doormat of those enterprises and individuals).

2. Most of the Government spending goes into the pockets of our own citizens. If they are enriching themselves from this spending, faster or more greatly than they should, then they are to blame and not the Congress. If they are worried about the budget, then toning down their bids for our unquestionably necessary defense and economic projects will go far to accomplishing their desires of tax reduction.

3. The high-bracket incomes were arrived at by people who had the prestige and power to set pay rates. They were arrived at by determining the net they needed (or could get) and adding the tax to it to leave the desired net—and when this wore thin, then they thought up the stock option and other unlimited expense account ideas—things not available to the grassroots man.

4. The same need of income applies to the lower brackets but they do not have the control. Taxes can only be paid from wages and if the tax reduces the takehome pay to less than the cost of living, then the employer must, of necessity, be approached for the difference—which brings up a labor problem.

5. For practical purpose, if a cut is decided upon, it might well take the form of a 1-year flat dollar deduction per taxpayer from his calculated tax for the year, as was done some years back. This would treat all citizens equally, and then give time for a more thorough study of various items of the revision.

6. All wages, salaries, and luxury expense accounts and extravagent building and research programs are reflected in the costs of operating a business and this includes all the direct business taxes. Consequently the purchaser pays the taxes.

7. There are too many different kinds of taxpayers and too many different kinds of income. For example, contributions of individuals, partnerships, and corporations should be treated in identical manner.

And in this connection, it is my belief that any organization which makes a charge for its services or which sells merchandise at a profit is in direct competition with the businessman, the small one in particular, and should be taxed accordingly. Furthermore, income from the investments of such organization should be taxable income. Without our Government they would have no reason to exist.

I have stressed this to such organizations for years but I observe that now the error of their ways is getting on their minds, as witnessed by the following article which was printed right smack dab in the middle of the Sunday church service announcements:

"[From the Church News Service, West Chester, Pa., Oct. 19, 1963]

"CHURCH-RELATED BUSINESSES STIR CONTROVERSY

"(By Robert M. Andrews, United Press International)

"'In California a man can grow a beard, get a private religion, build a chapel, and operate a business with a 52-percent advantage.'"

"So complains an unnamed churchman about the liberal tax exemptions that American churches traditionally have enjoyed, especially in business enterprises that have little or nothing to do with religion.

"His troubled view is expressed in a thorough study of the controversial issue, just published by the National Conference of Christians and Jews. The author is Andrew D. Tanner, a Nashville, Tenn., lawyer and authority on tax exemption litigation.

"Tanner cites others—leading clergymen and laymen alike—who express uneasiness over the church's special position in the tax laws.

"According to Tanner's report, the most widespread source of criticism is the way churches have entered competitive, profitmaking businesses without having to pay the 52-percent corporation tax on gross income.

"LAUNDRIES TO HOTELS

"Tanner cites these as some typical operations:

"One New Hampshire church operates a laundry. A major denomination's printing house, while grinding out tracts and Sunday School lessons, also prints supermarket trading stamps for profit. Other churches, or their organizations, own hotels, big-city office buildings, radio and television stations, sports stadiums, department stores, and industrial plants. One religious order, because of its tax-free status, owned a television station that sells advertising time 10-percent cheaper than its chief competition.

"Since 1950, all income of a church or association of churches has been tax exempt, whether its source is 'related' to religion or not, although most of it supports missionary and welfare work. Other charitable and educational organizations must pay taxes on 'substantially unrelated trade or business activity.'

"CHURCH AND STATE

"Arguments for and against removing or modifying tax exemptions go to the heart of the thorny issue of the separation of church and state.

"Those in favor say a tax exemption is a subsidy as real as if the Government made a cash gift equal to forgiven taxes. Those against, argue that churches should not be taxed because 'the power to tax is the power to control.'

"Tanner himself sides with the view that 'tax exemption is necessary to maintain a free church in a free state' and that 'any change should be slow and gradual.'

"As a start, he suggested that churches might volunteer to pay a reasonable amount for municipal services such as police and fire protection.

"And 'in view of the attitude of most church leaders,' churches should be required to start paying taxes now on business enterprises unrelated to religious activities, Tanner said. The same, he adds, should apply to church property not used exclusively for religious purposes, such as meeting halls rented to outside groups."

This is not a direct blow at the church; it is just an indication of what is done when loopholes are taken advantage of by humans. There are many foundations, societies, etc., which do likewise. And don't forget that to a very great extent, some of the things they do are made possible by solicited contributions which have been tax deductible to others in the past.

The official U.S. Treasury list of such organizations contains in excess of 45,000 names and this is by no means as complete as it should be (I refer to the volume I have in hand, printed in 1960).

No deduction of money or property, paid to anybody or any entity should be tax deductible to the disburser if it is not taxable to the receiver. Let's not have our Government do things through the back door of tax deduction which we don't want it to do through the front door of taxation.

8. We should publicize the responsibility of citizenship and overcome this special treatment of groups.

(*a*) Formerly, during my time in foreign countries, a citizen calculated his foreign tax, deducted this from his U.S. tax as though he were in the United States and remitted the difference (if he paid more outside than inside, he paid no tax). This would seem to be fair. We enjoyed the protection of our Government and were willing to pay for it.

(*b*) This will cause a howl, but some clergy already agree with me in this premise and other church tax matters—clergy are now generally no longer underpaid, and in such instances at least as they have attained a normal professional income, the rental of homes and other allowances should be taxed.

(*c*) Unnecessary "tax deductible" expenditures are actually 100 percent tax.

9. It is recommended that the current legislation contain stipulations that whenever the IRS and the courts are unable (or the Supreme Court is unwilling) to arrive at a conclusion on tax matters in a reasonable time, that it be referred to the Congress for clarification of intent.

10. Now something needs to be said about the tax base. There has for years been an ever-increasing emphasis on tax avoidance, fostered, I am ashamed to say, mostly by the banking circles and others who should have been exerting their efforts to a more solid tax system and on a more equitable basis.

11. There has been a growing cry of "soaking the rich" being wrong. I subscribe wholeheartedly to that cry—it is righteous. However, this cry is followed by the contention that the entire "take" from this group will only run the Government for 2½ days. That being the case, then the rest must come from business and the lower income group—so I guess that is the section that is really being "soaked." But let me reiterate what I said above, I don't think any of us are concerned really with the "take" but the way it is "thrown around"—and I also feel that those who object most loudly are the very ones who are clamoring for higher and higher Federal expenditures. I note for instance that while our Governor Scranton yelled against Federal expenditures during and after the last election, he is now in Washington asking for more and more.

12. We must raise the morality of this country and stop the acceptance of tax evasion as a virtue, and you will note I did not say tax avoidance.

So much for background—now referring to H.R. 8363.

TITLE 1—RATES

The matter of personal exemption should be studied as a proper basis for rate reduction. It would seem desirable to have a cost-of-living personal exemption which is more realistic than the $600 now allowed. Using such an adjusted figure would automatically lower incomes into lower brackets and give the same advantage to all taxpayers. The figure should be weighted to adjust to the problem of the single taxpayer, the married taxpayer with no dependents, the married taxpayer with dependents of varying numbers, etc. While this would drop many names from the tax roll and not make them conscious of the cost of Government, those names should be followed up on the IBM machines, or a token return be required.

The middle and low brackets are pinched more by the inflationary cost of living index and have less control over income than those in the higher brackets. The higher brackets were first to go up (and faster) and should be willing to be the last to seek reduction.

Another way to accomplish rate reduction might be to classify the various kinds of income (earned, business, rents and interest, capital gains, etc.) treat them all as ordinary income (other than in the case of risk capital discussed later), calculate the tax on each class at the lower rates and add them together for total tax. This would avoid pyramiding of the income into higher brackets. Of course, the rates would have to be readjusted to produce necessary Government income, possibly by a surtax on the total.

Current figures in the press indicate that the lower bracket folk can now look to about $12 per month tax cut while those in the upper brackets, which already have ample living capital, will get a hundred times that, and more. The $12 is like throwing a daisy to a cow in comparison. You can count on the $12 being spent to pay debts and help the small stores—the majority of the other deal will go into investment and a resulting clamor for more income—where is the purchasing power?

I think we should have the public roll out the old potbellied stove, and resurrect the old sawdust box and the plug of tobacco and sit down to figure this out. Let's develope a tax program which will be equitable, which will not soak the rich but will most decidedly not soak the poor nor widen the gap between the two levels. If we don't, we are heading for socialism just as certainly as we are heading for socialized medicine—and I don't think anybody really wants that—I certainly don't.

For instance, I observe in the press these days a suggestion that college tuition should be a deductible item—I shall refer to this later as a part of the "contributions" subject—it isn't exactly that, but the two are close cousins of the exemption spaghetti.

In short we should make the official Government cost of living figure the floor from which to build up the tax structure. Tax is in selling price anyway.

Averaging of fluctuating income

This is a very vital matter but it doesn't go far enough. All citizens and their business enterprises of all types have this same problem. Income averaging should be available on all tax returns.

It is believed that this would be a very great incentive for all businesses to keep pushing continually for their best consistent business volume, rather than slow up and possibly stop when the line of "tax expediency" is reached. We think this will have a very decided effect on employment stability. First of all, a private citizen does his best each year. Whether he is an author, an attorney, a schoolteacher, or a laborer, it is likely that some place along the line he will experience an occasional bonanza (maybe not as great as to one of these fields as to another, but a bonanza nonetheless). With the possible requirement that unemployment compensation should be included in the tax equalization calculation, it would seem proper that all should have like treatment. Low income or unemployed years should be considered as much a business loss carryover as it is for corporations to carry over losses. From a practical standpoint this has one weak spot, but it exists anyway—and that is that combines might decide we shall have only "good" times during one kind of administration and "bad" times during others and average out. I prefer to think such a narrowminded approach will not hold.

CAPITAL GAINS

As a relief to corporation taxes and to further overcome the "double taxation" idea, it might be well to allow corporations to retain a certain percent of net earnings before taxes, and then require the balance to be distributed to stockholders and permit this cash distribution to be deducted from taxable income. In addition the retained "tax money" would be usable working funds. This will produce current earnings distribution to stockholders, producing taxable income to offset corporate income tax loss. It would have a leveling effect on stock prices.

Those stockholders who desire to reinvest, could use this cash to purchase additional shares, so the matter of corporate funds should not be interfered with. These earnings which now become capital gain stock split distributions are to a great extent ordinary income which has been deferred in distribution.

I observe from page 1543 of volume 2 of the hearings before the House Committee on Tax Revision during 1961, that the Investors League presented in part, the following:

"appeal to fiduciaries and individual investors whose funds are largely invested in one or a few stocks which seem to be selling too high in comparison with other investments and where prudent investment judgment calls for diversification.

"It has been conservatively estimated that American investors in corporate stocks now have over $200 billion in unrealized capital gains, a large portion of which represents paper profits which they refuse to take because of the high

current rate of the tax on long-term capital gains. They can simply hold these until death and there will be no capital gains tax imposed.

"The long-term capital gains tax presently yields the U.S. Treasury no revenue of consequence—less than $1⅛ billion a year.

"After all, no one has to pay this tax unless he sells his stock. H.R. 4850 will encourage people of means to sell their frozen assets and reinvest their gains in medium-term Government bonds paying interest rates of only about half of what the Treasury would pay otherwise. After the redemption of these bonds in 5 years, many substantial investors would reinvest a substantial portion of the proceeds in Government bonds because sound investment policy at an advancing age would indicate that such investment would be most prudent.

"Reinvestment of a substantial portion of original principal and proceeds of sale of the 5-year bonds would undoubtedly go into new industries that would create profits from which the Government would obtain revenues from corporate taxation. The Federal debt would not be increased because of the congressionally imposed ceiling thereon. Proceeds from sale of the new bonds would be used for refunding or retirement of Government bonds now paying twice as much interest.

"Again, gentlemen, I urge swift and favorable consideration for this measure. Its limits are boundless, its indubitable effect on American economy will be summarily felt.

"The benefits would go far to unfreeze funds, billions upon which no capital gain tax is presently paid—frozen in and lying fallow—plant the seed and reap the harvest.

"Gentlemen, I thank you."

It would seem that the encouragement of distribution of corporate earnings currently would go far in releasing a vast part of the $200 billion to which they refer and would also go far in accomplishing what they urge in their closing paragraph.

Might I call to your attention that here, again, is another of those inequities in the tax structure. There is no more reason why the accumulating undistributed corporate earnings should produce capital gain stock income, than it is that personal business income and partnership income should be so treated.

The stock market, large land deals, and the like are susceptible to organized, planned, manipulation.

Extension of short-term gain holding period

This term should be extended not to 12 months but to 3 years. And preferably the whole concept of capital gains should be thoroughly looked into as one problem aside from general tax revision. The thought of "risk capital" should be encouraged. Just what is "risk capital" is another thing.

Capital which goes into the treasury of the enterprise is certainly risk capital and should have certificates issued to be so classified. When those certificates are sold and no additional cash goes into the treasury, it becomes just another horserace and such reissued share should not have such consideration, but should be taxed at higher rates as suggested.

The matter of stock issued as a result of stock splits should be studied and specifically treated.

CONTRIBUTIONS

There is no quarrel whatsoever with any contribution, but all of them should come from the heart and substance of the giver, or from the surplus of the corporation, and not indirectly from the Federal Treasury insofar as the tax avoidance amount is concerned. Remember particularly as to business contributions—that this amount is included in the selling price of the product or service.

If nothing else, contributions should only have a value of cost to donor and not some exalted valuation (unless the donor picks up the increment as ordinary taxable income). Personal services are not deductible, but I notice for example, that recently an artist was sustained by the courts in deducting some outlandish value for a painting that he had created and then contributed to a church. That's mostly personal income, I think. Also it comes to mind the drugs contributed by the large drug companies in the Cuban affair (and I don't question the motive in the slightest)—they deduct wholesale prices from their income, so they retain tax-free actual profit—their contribution was actually what it cost them to produce, package, and place the merchandise on the dock. You should not make a tax profit out of giving.

I observe from the press these days a suggestion that college tuition and expenses be considered as a proper deduction for taxable income. This would indeed be breaking the dam, not just making a lookhole or opening the barn door, but breaking the dam. You would find ocean liners (and there are smaller ones doing it right now) starting floating world cruise universities—there would be an immediate increase in the college costs, because the old cry of "it's tax deductible" would spawn just this; and it would squeeze out the very folk we should be trying to help, and it would result in further inflationary prices. And don't lose sight of the fact, that this entire cost of education is in the cost of goods sold paid by the purchaser, so any deduction from income is a direct Government subsidy—sooner or later we arrive at just what we claim we don't want—concentration of power in Government—socialization.

I take exception to the methods used for raising funds and more particularly just now the movement in on industrial payrolls, school payrolls, Armed Forces payrolls, etc., for mass deductions. It gives no heed to the economic condition of the employee—and let me add here it is my understanding that our own Governor Scranton is going to permit this same thing on the State payrolls. I call it coersion and alien to the American way of life and alien to the basic ethics of the very organizations which are doing it.

Secondly, encouraging devising of property or businesses to such organizations for the avowed purpose of avoiding taxes, simply raises the tax load on the donors progeny and others by reducing the taxable base. And eventually, if we keep it up to the end, nothing will be taxable, so where are we?

SUMMARY

We need to abandon the idea of special consideration and let everybody play this economic game under the same set of rules. We can't all be generals, but at least let's all be equal Americans, taxwise.

Draftees pay—I might even inject that if there is one class of citizens who are entitled to special consideration, it is that group of men who are drafted (or volunteer). Mostly they come out of better paying civilian jobs, willingly to a very great extent. It might be well to exempt the buck private income even to officers during first draft or enlistment. Reenlistment would mean they picked out a profession and that changes the aspect.

At this point I would like to introduce into the record an article which appeared in the Philadelphia Evening Bulletin, written by J. A. Livingston, financial editor, which will give some food for thought, in what I hope will be a continuing consideration of tax revision so that we come up with a truly democratic statute that we will be willing to live with.

I have the permission of Mr. Livingston to present this article.

"'THE BUSINESS OUTLOOK' FIRST PRINCIPLES GOT LOST IN PRESIDENT'S TAX PROGRAM

"(By J. A. Livingston, financial editor)

"What sort of a tax structure does the United States need?

"President Kennedy didn't raise that question when he addressed the symposium on economic growth in Washington, but he came close to it.

"He asked critics of his tax program to submit alternatives.

"If I had that problem, I'd ask for a clean slate. I'd return to first principles.

"An ideal tax structure would have these qualities:

"1. Simplicity—it ought to be easy to administer.

"2. Fairness—taxpayers in the same income bracket ought to pay the same amount of taxes.

"3. Mercy—but not sentimentality. Those who can best afford to pay should pay more than those not so well off. This brings in the principle of graduated taxation.

The first principle calls for rates as low as possible—with few exemptions, deductions, and loopholes.

"DOUBLE DISADVANTAGE

"Exemptions and deductions have a double disadvantage. First, they make administration difficult: What is and what is not a proper deduction? That takes definition and, at times, hair-splitting judgments and court decisions. Second, they discriminate between taxpayers: Should a person who lives in

a rented house have to pay higher taxes than a person who owns his own home and deducts interest on his mortgage?

"If simplicity were the sole base of taxation, a gross levy—no deductions whatsoever—would be imposed on income—that is, salaries, dividends, interest, rentals (after expenses), business profits, and so on.

"But we have consistently felt that dependency demands dispensation. Bringing babies into the world is encouraged. Therefore, some abatement of the tax—a flat deduction—is allowed for dependents, old and young. In this way, bachelors are discriminated against but society accepts this—perhaps because women outnumber men.

"ABILITY TO PAY

Then there would have to be graduation—the ability-to-pay adjustment. Twenty percent of $100 a week is far more of a burden—taxwise—than 20 percent of $300.

"What would these principles do to our present tax structure? They'd turn it topsy-turvy. They'd eliminate deductions for charitable contributions. Why should a man be granted a tax dispensation for making a gift to his university or to a hospital or an art museum?

"Does he have to be induced to do what loyalty and self-interest prompt? Is a gift to charity essentially different from a wedding gift to a distant relative or flowers to a hostess? Isn't it payment for past or hoped-for favors?

"Interest deductions (for nonbusiness purposes) likewise would be excluded.

"Ditto deductions for taxes paid State and local governments. Taxes are payment for service. You can't deduct the cost of telephone service or the price of the repairman who fixes your television set or washing machine. Why then should you be permitted to deduct the cost of police, fire, and similar protection?

"EXPLANATION WELL KNOWN

"Life is part lottery, part what you make it. Government—society—can't be the "all embraceable you" and take care of trials and tribuations not of its own making. We admire the 70-year-old man who stands tall and straight and enjoys life. But we give him a double deduction. Should we? We allow special deductions for medical costs and drugs. Should we? If we want to help the aged or ill, it's better to do it directly, not through exemptions.

"The explanation of these exclusions and complexities is well known. Rates got so high that Congress began handing out deductions and exemptions to the middle and upper income taxpayer. Then, these benefits began to spread downward. Now everyone gets an automatic deduction for taxes, charitable contributions, and interest, whether he has such outlays or not. And the President would even enlarge this in the new tax bill.

"Reform demands simplification—cutting the exemptions and deductions and moving toward a gross tax. If the President had offered such a program, he'd have won respect for trying—for fighting what every economist and tax specialist recognizes is a genuine necessity. As it is, he departed from first principles in an effort to please everybody."

It is a matter of great satisfaction to me to find that a citizen as relatively unimportant as I, has been given the opportunity to sit down with officials of the Internal Revenue Department and the Treasury Department and to have been permitted to testify before the House Ways and Means Committee and now before this committee on this matter. It shows that our basic rights in Washington are still alive. I am sorry to say that the same approach to tax legislation did not exist in Harrisburg even though our Governor proclaimed an open-door policy before his election.

UNION BANK,
Los Angeles, Calif., November 12, 1963.

HON. CLAIR ENGLE,
U.S. Senator, Senate Office Building,
Washington, D.C.

DEAR SENATOR ENGLE: The revised tax bill will probably not be acted upon this year but will receive attention by the Congress in 1964. In the hope it may not be too late to present a plan involving Federal estate taxes for your consideration, and for the consideration of the appropriate committees of Congress, I am presenting this thought to you at this time.

Based on my experience in seeing many estate situations and knowing of the concern of many persons about Federal estate taxes, I would like to urge upon you a new program with respect to inheritance taxes which would be beneficial to all concerned—the taxpayer, the Government, and the general economy.

Federal estate taxes can often result in requiring that a family business or personal assets be sold at a sacrifice in order to meet the tax obligation. Thus, a person who had worked diligently to accumulate an estate (and who at the same time paid heavy income taxes) has been deprived of the right to pass along a going business or a fixed asset to others as he may have planned. In addition, the Treasury Department is confronted with the serious problem of collecting taxes where liquid funds often are not available.

The only possible solution for the person anticipating a large Federal estate tax payment can be found in the area of insurance. Under today's insurance programs, one can insure himself against almost any disaster except that resulting from heavy taxes. I, therefore, propose that a person anticipating a substantial Federal estate tax be permitted to buy life insurance to provide the funds for this specific purpose.

Such life insurance would be purchased and irrevocably assigned to the Treasury Department of the U.S. Government as beneficiary. The premiums paid for the life insurance would not be tax exempt. However, the death benefits payable to the U.S. Government would not be included as a part of the estate of the deceased and, therefore, would not be subject to tax.

Were this procedure adopted, a man could make provision during his lifetime to assure the availability of liquid funds to pay the Federal estate taxes. In addition, the Treasury Department would receive immediately upon the death of the insured substantial estate tax payments. If the insurance were not adequate to pay the full inheritance tax, the difference of course, would have to be made up from the estate. If the insurance were greater than the amount required, an appropriate refund would have to be made to the estate.

This proposal would encourage additional savings, would be extremely beneficial in all estate settlements, and would facilitate the collection of inheritance taxes by the Treasury Department. I see no negative features in the plan. I would be very much interested in hearing from you concerning the possible introduction of legislation to accomplish the purpose I have suggested. Your advice would be most appreciated.

Sincerely,

HARRY J. VOLK, *President.*

LAW OFFICES,
DIXON, DEJARNETTE, BRADFORD, WILLIAMS, MCKAY & KIMBRELL,
Miami, Fla., November 20, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The Estate Planning Council of Southeast Florida is composed of attorneys, certified public accountants, trust officers, chartered life underwriters, and life insurance counselors who are engaged in estate planning in this area.

At its November 18, 1963, meeting, the executive committee, the governing body of the council, unanimously went on record as vigorously opposing any change in the basic rules of property transmitted at death. In the discussion of this matter, committee members expressed particular concern over the disruption of existing estate plans of long standing and the fact that most taxable estates are now required to sell assets to pay estate taxes and would thereby, in many instances, be forced involuntarily into realization of capital gains if the administration's proposal is adopted. We feel that estate taxes are already overly burdensome, and that the proposed change in basic rules would only make more harsh and desperate the problems which estate representatives are hard pressed to solve even under existing laws.

Very truly yours,

JOHN G. MCKAY, Jr.,
Secretary, Estate Planning Council of Southeast Florida.

LANCASTER CHAMBER OF COMMERCE,
Lancaster, Pa., November 21, 1963.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: On behalf of the Lancaster Chamber of Commerce, representing over 1,500 members, I should like to offer the following comments on H.R. 8363, the Revenue Act of 1963, which is presently before the Senate Finance Committee.

At the present time there is almost universal agreement that the Federal income tax rates are too high. The debate continues on where to reduce the rates and how much. This chamber of commerce, together with other business groups and many tax experts, is on record as supporting the rate reduction proposed by Representatives Herlong and Baker. H.R. 8363 falls far short of providing the substantial tax relief which is required to restore adequate incentives and stimulate economic growth. We hope that your committee will give careful consideration to revising the rate structure of the House bill so that it more closely approximates the rate structure in the Herlong-Baker bill. Revision of the rate structure of H.R. 8363 in the middle income tax brackets is perhaps most urgently needed, because here the progression is steepest and the amount of relief smallest. However, H.R. 8363 is helpful insofar as it indicates movement in the right direction, but we could support it only if Congress clearly indicates that it is only the first step in a series of individual and corporate income tax rate reductions.

Sharing equal pirority with tax reduction is the need for economy in Government. In our opinion the national economy cannot continue to grow unless the stifling effect of our present Federal income tax rates is alleviated. Even with the revival of incentives through a tax cut, sound growth cannot be assured unless fiscal responsibility is restored in Government. To accomplish this. Congress should declare a moratorium on all new spending programs and examine and reexamine all existing programs to eliminate all nonessential spending.

The Revenue Act of 1963 is not only defective in its rate structure, but it is defective with respect to many of the structural "reforms" which it would impose. Among these are—

1. The repeal of the dividend credit. The very limited relief from double taxation afforded by the 4-percent dividend credit should not be repealed, but rather increased in order to stimulate the flow of equity capital.
2. The imputation of taxable income to individuals by reason of the payment or partial payment of group-term life insurance by employers is a particularly unsound provision. If section 203 of the bill were aimed only at curbing discriminatory plans, then many objections to this part of the bill could be eliminated.
3. Section 212 removes an inconsistency in the law by providing old employees and new employees with the same tax treatment with regard to reimbursement of moving expenses. However, this amendment does not go far enough in that it does not clearly exempt from tax reimbursement of employees for expenses associated with moving, such as house-hunting expenses, costs of disposing of the old home and acquiring a home at the new location, and temporary traveling and living expenses pending completion of the move. These reimbursements do not represent any economic benefit to the employee and in all fairness should not be taxed.
4. The repeal of the multiple surtax exemption will be a real blow to many small businessmen throughout the Nation. Through the "business purpose" doctrine the Treasury already has ample means of policing the indiscriminate proliferation of related corporations. Further legislation in this area is not needed. However, if the multiple surtax exemption is disallowed, then, at the very least, Congress should restore to the Revenue Act the provision granting a 100-percent dividend received credit on dividends from related corporations—this provision was recommended by the President.

We would be unfair to the draftsmen of H.R. 8363 if we would not comment upon those sections which we do consider desirable changes in the law. The amendment to the investment credit provisions of the Internal Revenue Code removing the required downward adjustment of the basis of depreciable prop-

erty is a much-needed and desirable simplification. Also the establishment of a new class of capital gains for assets held more than 2 years with the resulting lower rate of taxation is to be commended and will have a desirable effect in providing greater investment mobility. However, on balance, we regard the bill which is now before your committee as a bad bill, unless the tax rates are revised to provide substantially more aftertax incentive or Congress commits itself to further tax reduction in the immediate future. As for the reforms, we would suggest that the entire matter of structural reform be eliminated from the bill and that Congress set up a commission to study the Internal Revenue Code to the end that genuine reform can be introduced—reform which would have, as its objectives, simplicity and equity.

In conclusion, Senator, let me express to you my personal appreciation and the thanks of our many members for the inspiring service which you have long rendering our country in promoting economy and efficiency in Government.

Sincerely yours,

DANIEL B. STRICKLER, *President.*

MORGAN, LEWIS & BOCKIUS,
COUNSELORS AT LAW,
Philadelphia, Pa., November 22, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR CHAIRMAN BYRD: We have been following developments concerning the pending revenue bill very closely, with particular reference, of course, to any changes in the Internal Revenue Code which may affect the interests of any of our clients. In this connection, we should like to bring to your attention a significant departure from present law under the House version of the bill, which, to the best of our knowledge, has not been specifically explained or discussed in any published commentary. The question with which we are concerned relates to the provision of the Internal Revenue Code for a maximum effective rate of tax appreciably below the highest bracket. Thus, under present law, the top bracket is 91 percent, but the overall effective rate is limited to 87 percent—Internal Revenue Code section 1(c). This provision will, of course, become meaningless for any year in which the top bracket is less than 87 percent. Under the House version of the bill the limitation would, in effect, be abolished for all future years.

We respectfully suggest that if tax rates are to be reduced, the reduction should be implemented without an implied repeal of the effective rate limitation. This limitation has been an integral part of our income tax structure for almost 20 years, and we believe that any proposal to abandon it, directly or indirectly, should be subjected to the closest scrutiny.

Five copies of a memorandum in support of the retention of the limitation at a meaningful level are enclosed. We hope that it will be possible for the committee to give due consideration to this matter in the course of its review of H.R. 8363.

Very truly yours,

H. PETER SOMERS.

MEMORANDUM IN SUPPORT OF RETENTION OF MAXIMUM EFFECTIVE RATE PROVISION

The top income tax bracket at the present time is 91 percent, but this is subject to an overall effective rate limitation of 87 percent—Internal Revenue Code section 1(c). The revenue bill of 1963, H.R. 8363, provides for a reduction of the top bracket to 77 percent for 1964 and 70 percent for subsequent years. The bill, however, contains no provision for a corresponding reduction in the effective rate limitation, and consequently this limitation would become meaningless for future years if the bill is adopted in its present form. It is submitted that, in order to avoid this result, a new and lower maximum effective rate should be adopted.

I. THE MAXIMUM EFFECTIVE RATE LIMITATION IS AN INTEGRAL PART OF THE PROGRESSIVE RATE STRUCTURE AND SHOULD NOT BE REPEALED BY IMPLICATION

During the past 20 years Congress has repeatedly had occasion to consider the question whether there should be a maximum effective rate of tax at a level below the top income tax bracket, and in each instance Congress has answered this question in the affirmative. Although the differential between the top bracket and the effective rate ceiling has fluctuated over the years, ranging from 1 percent in 1944 to 11 percent under the Revenue Act of 1948, the basic principle of not taxing an individual at the top bracket beyond a certain point has been consistently respected. Moreover, this principle has been specifically recognized and applied in connection with the most recent reduction of the top income tax bracket. Under the Revenue Act of 1945 the highest rate was reduced from 91 to 88 percent; at the same time, the effective rate ceiling was reduced from 90 to 85.5 percent.[1]

Absent any compelling argument to the contrary, there would appear to be no justification for a departure, by implied repeal, from established precedent in this area.

II. THE NEUTRALIZATION OF THE EFFECTIVE RATE CEILING UNDER THE HOUSE VERSION OF H.R. 8363 IS INCONSISTENT WITH THE STATED PURPOSE OF THE BILL

The fundamental objective of H.R. 8363 is to stimulate economic growth through tax reduction. This requires, inter alia, an increased rate of capital formation. As recognized by the Ways and Means Committee, rate reduction in the upper income brackets is the most likely source of funds for increased capital investment.[2]

The significance attached to rate reduction in the top bracket is further emphasized by the fact that, except for the very bottom brackets, the largest reduction (23 percent) is reserved for the highest bracket. In the words of the House report, the bill "provides larger reductions in the very highest bracket where it is quite clear the present rates are too steeply graduated."[3] Relief in the top brackets therefore is, as a matter of economic policy, a primary objective of the pending tax legislation.

It is submitted that unless the effective rate limitation is retained at a meaningful level, the policy objectives underlying the rate reductions in the top brackets will be largely frustrated. Indeed, in the case of a high-bracket taxpayer whose income consists primarily of dividends, the repeal of the 4-percent dividend credit alone serves to neutralize to a substantial degree the intended beneficent effects of the proposed rate reduction. But if the repeal of the dividend credit were to be coupled with an elimination of the effective rate ceiling, the highly publicized rate reduction for the high-bracket taxpayer would, to a significant degree, turn out to be illusory, and the repressive effect of excessive tax rates would continue to sap the vitality of our economy. Certainly, it cannot be the intent of Congress to provide an economic stimulus through rate reduction with one hand, while at the same time quietly administering an economic sedative with the other hand in the very situations where the stimulus was calculated to be most fruitful.

It is perhaps not an atypical case that the individual with a very large income is a substantial shareholder in a corporation, the success of which is primarily attributable to the efforts of such shareholder and his family. The repeal of the dividend credit does much to stifle such person's enterprise and reduce his aftertax income available for reinvestment. The removal of the effective rate ceiling would compound the negative social and economic consequences under the proposed bill.

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[1] The House report accompanying the bill pointed out that the effective rate ceiling should be reduced by the same percentage as the general reduction of individual rates. H.R. 1106, 79th Cong., 1st sess. 5 (1945). The bill, as finally enacted, maintained this proportion in the relevant brackets. Applying this approach to the pending bill would suggest the establishment of a new ceiling at 74 percent for 1964 and at 67 percent thereafter.

[2] H.R. 749, 88th Cong., 1st sess. 7 (1963).

[3] H.R. 749, 88th Cong., 1st sess. 20 (1963).

III. FAIRNESS REQUIRES THE RETENTION OF AN EFFECTIVE RATE LIMITATION

Little has been said so far about fiscal fairness and taxpayer morale. These are elusive concepts, but their significance is nonetheless universally recognized. A steeply graduated personal income tax, such as ours, can be defended, if at all, only on the ground that fairness requires a progressive rate structure. But in the case of taxpayers with very large incomes, the graduation of rates becomes meaningless, for the highest bracket in substance becomes their effective rate. Such discrimination against those who already bear the heaviest tax burden seems wholly indefensible. If fairness requires the graduation of rates, it also requires that such graduation does not become an instrument of oppression by transforming the top bracket of an ostensibly progressive rate structure into an effective rate of tax for the taxpayers with the largest incomes. The retention of an effective rate ceiling significantly below the highest tax bracket is therefore an indispensable concomitant of a fair and equitable graduated income tax.

For the reasons stated, it is respectfully submitted that H.R. 8363 should be amended to preserve an effective rate limitation significantly below the highest tax bracket.

STATEMENT OF ALFRED P. DIOTTE ON BEHALF OF THE WRITING INSTRUMENT MANUFACTURERS ASSOCIATION, INC.

INTRODUCTION

My name is Alfred P. Diotte. I am secretary of the Parker Pen Co., Janesville, Wis., and president of the Writing Instrument Manufacturers Association, Inc. Our association members produce fountain pens, ball pens, and mechanical pencils. The industry which they represent provides employment for approximately 18,000 U.S. citizens.

Our industry takes pride in the fact that it plays such an important role in the American way of life, facilitating as it does written communication at every level. Thus it provides the basic tools of American education, services American commerce, and promotes friendliness and good will among American everywhere. It is not unlikely that every Senator here today is carrying or using one of the products of our industry.

The Writing Instrument Manufacturers Association, Inc., is pleased to have this opportunity to present its statement with respect to H.R. 8363 to this honorable committee. Our association has been following the administration's tax proposal very closely and, in March of this year, testified before the House Ways and Means Committee. At that time we pointed out that a reduction in the corporate tax rate would free corporate funds for investment and result in a healthy stimulation of the economy. We stressed, however, that the administration's contemplated tax reduction spread out over 5 years (1963–67) would hardly generate the more immediate kind of tax relief needed to "get America moving again." In this connection, we want to commend that honorable committee for reporting out a bill which would accomplish full tax reduction agreed upon by the committee within 2 years (1964–65) and thereafter.

From my discussion with the business leaders of our industry, I would say that the general consensus is that Federal tax reduction would put an immediate zest into the Nation's economy. Thus they reason that as American industry receives additional capital from a reduction in taxes, it would be better able to improve its products and productive facilities. And in so doing, American industry would provide a basis for expansion of markets not only in this country but also abroad. They note that such expansion would assure presently employed workers of jobs in the future and also would create new job opportunities for our Nation's expanding work force.

In any discussion of Federal taxes, however, these men are quick to point out that their excise tax burden is far more onerous than their income tax liability. Because of their concern—which I share—and as we understand there is a real desire in the Congress to know the facts in this area and to accord relief if warranted, as a part of the general tax reduction program, may we now direct our comments to the manufacturers' excise tax currently applicable to fountain and ball pens and to mechanical pencils—the products of our industry.

This excise tax, which is equal to 10 percent of the price for which those items are sold, has proved itself to be a particularly onerous burden for the American writing instrument industry.

TAX NO LONGER JUSTIFIED AS A MILITARY NECESSITY

As you know, the tax was proposed in 1951 as a means of partially meeting the increased military expenditures occasioned by the Korean war. More specifically, it was suggested that the luxury tax on jewelry be extended to include fountain and ball pens and mechanical pencils.

The Korean war has long since passed. And no one today seriously suggests that the tax is necessary to defray increased military expenditures. Of the approximately $50 billion authorized last year for defense, the excise tax on fountain pens and ball pens and mechanical pencils represented about one-seven thousand five hundredth ($6.5 million).

While this is a large sum of money, standing alone, when we tie it to its intended purpose we see that it represents only a very small fraction in the total picture.

If the tax cannot be continued to be justified in terms of military necessity, can we properly suggest that its continuance is warranted on the grounds that these writing instruments are jewelry—a luxury item?

WRITING INSTRUMENTS ARE NOT JEWELRY OR OTHER LUXURY ITEM

May it please this honorable committee, I submit that this proposition constitutes an abject departure from the realities involved. The average ball pen sells for 11 cents. To this price must be added a 1.1 cent excise tax. In these circumstances, can it be seriously contended that this article should fall into the category of jewelry?

If pens and mechanical pencils were luxury items, we would expect them to sell for luxury prices, in not less than the "$5 to $10 and up" range. The fact is, however, that today the average price for fountain pens is only 64 cents, the average price for mechanical pencils is only 33 cents, and, as stated, the average price for ball pens is only 11 cents. These prices hardly are in the luxury category.

Certainly, it is not necessary to burden this committee with a prolonged and reasoned analysis demonstrating that writing instruments are not luxury items. The fact speaks for itself. Suffice it to say, however, that current industry estimates indicate one-half of all pens and mechanical pencils produced in the United States are used by American students and schoolchildren.

To write, to put on paper the conscious thoughts of the human mind, is one of the most lofty of all human acts. And, in this connection, may we respectfully suggest to this committee that the employment of a writing instrument for this purpose is clearly an act of utility and not one of luxury.

The argument that the tax on fountain and ball pens and mechanical pencils is justifiable as an extension of the jewelry tax is patently frivolous. No one could seriously contend that the hundreds of millions of ball pens produced annually should be classified as jewelry. Yet the fact remains that this philosophy does constitute the basic rationale for the imposition of the Federal excise tax on these items.

SCHOOL ARTICLES TRADITIONALLY EXEMPT FROM EXCISE TAX

We have noted that one-half of all pens and mechanical pencils produced in this country are used by American schoolchildren. While footballs, baseballs, and other recreational items for the youth of America attending school are exempt from excise tax, the Government continues to impose an onerous excise tax on the basic tools of American education—fountain and ball pens and mechanical pencils. This constitutes a direct, unnecessary, and unwarranted penalty on the American student and is contrary to the administration's espoused philosopsy of aiding wherever possible the cause of American education.

PAST ILLOGICAL LUMPING OF WRITING INSTRUMENTS WITH LUXURY ITEMS IS NOT A PROPER GROUND FOR CONTINUED DENIAL OF RELIEF

The argument has been advanced by some Treasury Department officials that the excise tax on pens and pencils should not be removed because it would be unfair to remove an admittedly discriminatory tax on utilitarian instruments of education unless the excise tax on "luxury items" was simultaneously taken away. In other words, all excised so-called luxury items (including fountain and ball pens and mechanical pencils) should be removed at the same time.

This is a grotesquely specious argument. The fact that writing instruments were mistakenly classified as jewelry does not mean that the mistake should be compounded and continued year after year until some magic date many years hence when the Congress should decide to vote for an across-the-board removal of all excise taxes on luxury items.

GENERAL NEED FOR REVENUE NOT A PROPER GROUND FOR DENIAL OF RELIEF

May it please this honorable committee, we are happy to report that we have been given a good reception by Congressmen, Senators, and Treasury people, all agreeing that we—and the public—need and are entitled to relief. For a number of years the Treasury Department has been sympathetic to the repeal of the excise tax on writing instruments but would not recommend such action to the Congress because of the revenue loss involved.

In this connection, we submit that if the Treasury Department can recommend a revenue loss of $11 billion at this time through rate reductions, then any objection it may have to the repeal of this discriminatory wartime excise tax does not really exist.

DISCRIMINATORY TAX TREATMENT

May it please this honorable committee, the continued imposition of an excise tax on fountain and ball pens and mechanical pencils constitutes an unfair and discriminatory tax on one segment of American industry. If the tax ever was warranted—and there is no reason to debate the issue at this late date—it obviously is not warranted on any grounds today.

As Mr. Edelmann pointed out in his recent testimony before your committee:

"The strongest reason for the enactment[1] of wartime excise taxes was that they were admittedly repressive and would put a brake on the businesses affected. *They were intentionally diversionary and punitive in order to meet wartime necessities. Since they continue to repress and divert in peacetime, they are discriminatory and unfair.*" [Emphasis supplied.]

We agree with him that the time for the repeal of these taxes is long overdue.

As matters now stand, only a relatively few industries are singled out for the imposition of manufacturers' excise taxes on their products. In our own case, this places us in a highly disagreeable competitive position with a number of untaxed products sold in direct competition with mechanical writing instruments. Elimination of excises on our products and paying to the Federal Treasury the same corporate tax rates as our competitors pay would again place us on a fair competitive basis.

REQUEST FOR RELIEF

Accordingly, while this honorable committee contemplates the Nation's need for general tax relief, may we respectfully suggest that it not overlook an opportunity, by simple amendment, to remove the excise tax on fountain and ball pens and mechanical pencils. In this connection, may we respectfully call the committee's attention to H.R. 1006, introduced by Congressman Osmers, Republican, of New Jersey, this session, which contains the necessary implementing language to straighten out a situation which in justice and simple equity demands correction.

In conclusion, may we thank this honorable committee for this opportunity to bring this matter to your attention.

Thank you.

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[1] Excerpt from the testimony of Mr. Chester M. Edelmann, on behalf of the American Retail Federation, before the Senate Finance Committee on Oct. 28, 1963.

POLICIES TO ACCOMPANY TAX REDUCTION [1]

(Submitted by Raymond J. Saulnier, Barnard College, Columbia University, New York, N.Y.)

The policies pursued by our Federal Government in economic matters are always important to one's estimate of the busines outlook, but I can't recall a time when they have been more completely governing in this regard. Moreover, the policies we pursue in the months immediately ahead will have a critical bearing also on our chances for achieving steady as well as vigorous economic growth over the rest of this decade. And this latter point is especially important when we consider the exceptionally heavy need for additional job opportunities which will confront us between now and 1970. What, then, should be our policy strategy?

One's answer to this question must of necessity begin with a critique of policies currently in force and of those planned for the immediate future. Now it happens that I have serious reservations about a number of aspects of the administration's economic policies. Especially, I have had, and continue to have, serious reservations about its fiscal policies and about the theories that underlie them. In language as plain as I could find, I have said that I thought it was unwise to cut taxes by about $5 billion a year when (i) Federal spending as measured by cash payments to the public was rising at the rate of about $6.5 billion a year, as it did in the 12 months which ended August 31, 1963; (ii) we were already running a deficit in the cash budget of the Federal Government of over $5 billion a year; (iii) we had a deficit in our balance of international payments which we seem unable to reduce below the $2 billion a year annual rate and which, in the second quarter of this year, passed above the $5 billion a year mark; (iv) the money supply, narrowly defined to include only currency and demand deposits, was expanding by just under 4 percent and, more broadly defined to include commercial bank time deposits, by more than 8 percent; (v) consumer credit and home mortgage debt were each rising by about 10 percent a year; (vi) the economy was rising at a good rate and unemployment among those persons who comprise the bulk of our experienced and continuing labor force, as measured by the rate of unemployment among married men, was only 1 percentage point or less above what it was in 1955–56 and was trending down at a good rate; (vii) the consumer price index was rising, as it has been since last January, at a rate of between 1.5 and 2 percent a year and increases in prices of industrial materials were accelerating and becoming more widespread. As these conditions attest, our economy has been under strong expansionary pressures. I have thought it unnecessary and unwise to add to these pressures a large-scale, emergency-type, across-the-board tax reduction.

In a certain sense this has been a minority view, but it has been far from lacking in support. In fact, strange as this may seem, at a time when taxes are as high as ours are and when tax relief is so much desired, there has been little or no truly popular demand for Federal tax reduction. You can be sure that if there had been, it would not have been deemed necessary to have a Businessmen's Committee for Tax Reduction in 1963. And it would not have been deemed necessary for the President to go before the Nation on TV to muster support for a program which would cut people's taxes.

But do doubts on these matters mean that we should advocate abandoning the tax reduction program now under consideration in the Congress? I would say "No." It is by no means too late to specify the policy conditions that should accompany a tax cut; indeed, it is vitally important to do so. But I have concluded that at this time there is no reasonable alternative to enactment of the program. It is regrettable that a major policy question of this type has to be resolved in a kind of "no options" context; but as things stand now the prospect of tax reduction has been so thoroughly built into expectations and planning, and to some extent also into the financial commitments of individuals and businesses, that it would be seriously deflationary to call it off. As a practical matter, we are to all intents and purposes committed to it. Mind you, I am not saying that the bill as it stands is unalterable, because it isn't. No bill still in the Congress is unalterable, and that is precisely as things should be. What I am saying

[1] Based on remarks by Dr. Raymond J. Saulnier, professor of economics, Barnard College, Columbia University, and Chairman of President Eisenhower's Council of Economic Advisers (1956–60) at the dinner meeting of the 11th Annual Economic Outlook Conference, sponsored by the Department of Economics of the University of Michigan at Ann Arbor, Thursday, Oct. 31, 1963.

is that at this point to call off tax reduction as a program would be seriously deflationary and unwise.

Actually, there is very little chance that the bill will fail of enactment. But for two reasons, each sufficient in itself and, jointly, overwhelming, I expect it is going to take some time yet to get it passed. First, the administration proposed a very complex bill, with numerous technical and controversial features that cannot be passed on quickly. Second, the bill was put before the Congress and the country as part of an overall fiscal program and philosophy about which large numbers of people—I think, the great majority of Americans—have grave doubts. In these circumstances, speedy enactment cannot be expected. I don't understand why, if the administration desired a tax-reduction program in a hurry, it chose to do things in this way; but that, too, is water over the dam.

So we are, at least as I see it, committed to giving our economy a major stimulus sometime in 1964 and again in 1965 through an emergency-type, demand-increasing tax reduction. What remains to be discussed is the expenditure, debt management, and monetary policies that should accompany tax reductions of the type and scale in prospect. It is my purpose in this paper to sketch what I think these accompanying policies should be.

My view on this question is that by committing ourselves to tax reduction in the manner and in the amount contemplated we have, knowingly or not, committed ourselves to certain lines of action in other areas of policy as well. Certainly we have committed ourselves to placing a genuine check on the increase of Federal expenditures, by which I mean to hold the total at its current level. I would say that we have also committed ourselves to debt management and monetary policies under which a distinctly closer rein will be held on increases in credit and in the money supply than would otherwise have been necessary.

These are the major arms of policy: Taxation, Federal spending, debt management, and control of credit expansion and the money supply. They must be harmonized in an overall strategy. What we do with one arm has a very definite bearing on what we are free to do with the others. That is why we will find that just as events have committed us to the initiation of an expansionist tax-reduction program, the logic of the economic process will require that we follow neutral and possibly even restrictive lines of action in the other major areas of policy. We will have to do these things not just because they are the lines of policy that will serve us best in the current economic context and in the context that we can see developing over the near term, but also because, taken together, they constitute the strategy of policy best suited to bring us into the second half of the 1960's without a serious interruption in our growth rate and hopefully without any interruption at all.

My reason for believing that we are committed to policy choices along the lines I have described is that if we were to add emergency-type, demand-increasing tax reduction of the amount and type contemplated in the bill now before the Senate Finance Committee to Federal expenditure increases on the scale we have been getting them, and if we were to add both of these to monetary and credit expansion at rates such as we have recently experienced, we would be asking for trouble and that this would very quickly become evident. What kind of trouble would it be? It would be the kind of trouble that any enterprise economy encounters when it is exposed to excessive expansionary pressures. Let me be specific.

First, an aggressively expansionist economic policy carried out in the present economic context would invite the development of speculative excesses. These can appear in many places in our economy, but no place is more vulnerable to them than the stock market. If, under the stimulus and encouragement of expansionism, stock prices were to rise to heights that could be validated and substained only by a price inflation inconsistent with the stability of our economy and with the strength of our competitive position in world markets, then there would inevitably be a correction and the effect on our economy would be severely deflationary. Clearly, we want to avoid this, but an overdose of expansionism would invite it.

Second, when economic policies are excessively expansionist consumer purchases of durable goods and the investment expenditures of business concerns tend to be telescoped into a shorter period of time than that over which they would otherwise be spread. All of this may seem fine and boomish while it is happening, but it normally proves to be unsustainable and its correction, also, is severely deflationary. Moreover, the more expansionist the mix of policy, the more exuberant the responses and the more disruptive the ultimate correction.

Third, when an economy is operating at a high level, as ours is today, it is a very easy matter for aggressively expansionist policies to produce widespread cost and price increases. These reinforce the speculative excesses and the unsustainable surges of expenditure to which I have just alluded. In addition, they tend to worsen a country's position in world competitive markets, which we can ill afford to have happen at this time. To boot, cost-of-living increases impose cruel inequities on large numbers of people whose security and welfare is heavily dependent upon a stable purchasing power of their dollars.

A further comment on this matter of cost and price inflation is called for because not everyone believes, as I do, that our economy is vulnerable to it. In fact it has become rather fashionable of late, not only to discount the possibility of such things ever happening in the United States, but explicitly to disparage the efforts that were made in the mid- and later fifties to end the inflation and the inflationary psychology that were then taking hold in our economy. The January 1963 report of the Council of Economic Advisers is an example of this point of view. Let me say that I was far from persuaded, let alone personally enchanted, by those passages in the report in which the casual view of inflation which I have cited was given official expression and in which a lag that is alleged to have occurred in our economy after 1956 was diagnosed as having been caused by a needless concern over cost and price increases and, based on this mistaken concern, by fiscal and monetary policies that were unnecessarily restrictive.

Now, it is perfectly true that a major object of policy in this period was to work toward a reasonable stability in costs and prices. And fortunately we had a good deal of success in both of these connections. Indeed, it would have been a very serious matter if we had not been successful. Has it been overlooked that the index of consumer prices was rising in 1957 at a rate which, if it had continued without interruption, would have meant a cost-of-living today close to 20 percent higher than that which now prevails? But that is a fact. And there was a potentially very troublesome inflationary psychology building up in the middle fifties. We had complete success in ending it.

It has been said that all of this was done at the expense of our rate of economic growth. But the fact is that there were a lot of things other than Federal economic policies bearing on the rate of growth of our economy in the years in question. Not the least of these was the fact that the whole steel industry was shut down from one end of the country to the other for almost 6 months in 1959. But even then it is only by invoking a small and short-lived change in the rate of inventory accumulation that one can identify a 1960–61 recession in gross national product.

And I would argue, further, that the relative stability of costs and prices which the policies pursued in 1959–60 helped to achieve has been a major factor accounting for the growth and stability we have experienced in recent years. Does anyone really think that the chances of achieving steady and vigorous economic growth after 1960 would have been greater if consumer prices had been rising annually at the 3½ percent rate that obtained in 1957? And suppose we had had labor cost increases after 1960 averaging to something like 5 percent a year, as we had them in 1953–57? Would this have been a favorable context for growth? And looking to the future: Would the economic outlook for 1964 and beyond be improved if we faced the prospect of a resumption of cost and price increases like those that were occurring in the mid-fifties? I say that the answer to this question is "No." And because this is the answer, I say it is clear that we should avoid policies that would invite the resumption of cost and price increases on this scale.

This brings me to the fourth kind of trouble that would be invited by an excessively expansionist mixture of economic policies. The danger is that such policies, because they would inevitably result in unacceptable cost and price increases, would invite more and deeper intervention by the Federal Government directly into the affairs of American business and of American labor. In other words, such policies do more than invite inflation; they invite direct controls.

Fifth and last, an excessively expansionist combination of economic policies would almost certainly worsen our international balance of payments. I know it is frequently asserted that a tax reduction program will benefit our balance of payments by making America so much more prosperous, and therefore so much more attractive to foreign investment, that the resulting increase in the net inflow of long-term capital will perhaps even close the payments gap. This is possible, provided the tax reduction is accompanied by a suitable combination of other policies, but if it is accompanied by a combination of expansionist

policies designed to make our economy go faster and faster it might rather have the effect of discouraging foreign investors from making long-term investment commitments here. Certainly, if we accompany tax reduction with a still rapidly rising volume of Federal expenditures, and if we finance the resulting deficit in appreciable part through the banking system so as to avoid an increase in long-term interest rates, and, further, if we allow freer access to the central banking system for general credit expansion purposes, also to avoid higher interest rates, we will have established conditions that will invite a deterioration in our balance of payments. And, what could be acutely embarrassing, we would risk discouraging our friends abroad from helping us finance, as they have been doing on a very generous scale, the payments deficit that our policies would be tending to increase.

It is quite possible that since events have committed us to an emergency-type, demand-increasing tax reduction program we may find it necessary to accommodate ourselves to higher long-term interest rates. This should be understood only as a possibility, however, rather than as a certainty. Interest rates have already risen a bit, but no one can say at this time whether the present rate structure can be held or whether a further increase is in store. This will depend on how stimulative the tax cut proves to be, on the course of Federal spending, on the size of the Federal deficit, on how it is financed, and on the pressure of private credit demand. If long-term interest rates rise sufficiently to become a kind of conversation piece, the rise will inevitably be protested. But we are getting to be more understanding in these matters and I hope we will see that the best way in the present circumstances to minimize the need for interest rate increases, and possibly to avoid them altogether, is to check the increase in Federal spending. And though opposition to a realistic interest rate policy is very strong, I believe that under present domestic and international economic conditions a higher level of long-term interest rates, if it should be needed, would soon prove its usefulness and would eventually gain wide acceptance.

Those who would take exception to these policy proposals would do so, in most cases I expect, on the ground that only a distinctly more expansionary policy mix would give assurance of avoiding recession, now that we have reached such an advanced stage in the current business cycle.

This is a judgment question, and one's judgment on it depends on one's estimate of the near and intermediate term outlook for business, given the stimulus of tax reduction. But it also depends—in any case it should depend—on one's view as to how we can best navigate through 1964 and into the second half of the 1960's, when the underlying factor of family formation should be uncommonly favorable, without any serious interruption in our economy's advance and, hopefully, without any interruption at all. Let me comment briefly, first, on the near- and intermediate-term outlook.

As I read the evidence, it suggests that the expansion which went ahead at a rapid rate in the first 6 months of this year, but which has made only relatively little additional progress since last July, will continue through the rest of this year and into 1964 at the current relatively modest rates. Although I would expect expansion to accelerate under the stimulus of tax reduction, I do not look for as sharp an increase as some apparently do. This conclusion is suggested by the usual evidence to which we look for clues in these matters, and by certain conditions peculiar to our present status and outlook, as follows:

First, we have already reached a fairly high level of utilization of capacity in our economy. Expansion beyond this level will be made only with increasing difficulty. I know that this is a disputed point, but all the evidence around us is telling us that this is the case. That is what the price increases that have cropped up recently are saying. And that is what we read in the figures on unemployment. Here I would cite especially the fact that the unemployment rate for men who are heads of families has, except for a brief reversal last winter, been trending down since early 1961. It is now under 3 percent and is not much above the low levels reached in 1955–56. What is most important of all, it is continuing to trend down.

Second, the evenness of our economic development in the current expansion suggests a moderate rate of growth in the months ahead. Perhaps because it is something of a paradox, it is one of the least well understood features of the growth process in an enterprise economy that sources of future strength in demand are typically found in areas that currently display a degree of weak-

ness, and vice versa. Where there has been for some time no notable weakness in demand, there is not likely to emerge any great surge of strength. And the latter is more or less our present situation: demand has been strong in pretty much all areas for a rather long time. But this is no cause for lamentation; it means we have a good chance to make progress steadily, which should be ground for rejoicing.

Third, although I would be hard pressed to prove this point, it is my impression that when it comes to the undertaking of substantial new long-term purchasing or investment commitments a presidential election year is, on balance, more likely to be a year of deferral than a year of initiation.

Fourth, and finally, while the tax reduction program will be stimulative to our economy, I do not expect it to have the explosive effect that some people seem to be looking for. For one thing, I believe we have already had a good part of the expansive effect which the increment to income from tax reduction is expected to produce. In other words, we have had part of the multiplier effect before we got the initial stimulus. Beyond that, there are bound to be substantial leakages from the effect of the tax cut, especially in view of the recent large increase in consumer and mortgage debt. Also, the dollar amount of tax reduction that will be received per family will be so small that it will have a nearly unrecognizable effect on their aftertax money income and, for this reason, not much effect on purchasing of the high ticket items that make the economic world go round. It is true that when one multiplies even small average weekly amounts by 50 million, which is about the number of taxpayers, one comes to some rather large sums. These sums will represent a substantial impact at the retail level, but it is easy to exaggerate their influence, and especially their influence on jobs.

Returning to the policy questions, if I am underestimating the tax cut's stimulative effect there will be all the more need for a policy mix such as I am proposing. I want to acknowledge, however, that if even I am overestimating the tax cut's stimulative effect, there will be less occasion for restraining measures than I am expecting there will be. We will not know for sure until some time in 1964, but I am certain enough at this time in my estimate of the situation to advocate a policy mix of the type I have described. The danger, as I see it, is not that a tax cut accompanied by a cessation of Federal expenditure increases, and by debt management and monetary policies that will slow down the rate at which credit and money supply have been expanding of late and perhaps even cause interest rates to rise a bit, will supply insufficient stimulus to our economy. The danger, as I see it, is that in an effort to make the economy go faster and faster, we will have not only a tax cut but Federal spending increases at the rate we have been getting them recently; namely, at $5 billion or more a year, and that resistance to interest rate increases will tempt us into Federal debt financing and monetary policies that will mean a continuation of money supply and credit increases at rates comparable to those we recently have been getting or higher. An aggressively expansionist policy of this kind might be exciting for awhile, but in the end it would prove to be bad news. It would mean that we were pushing our economy too hard. The penalty would be a bad reversal further down the road. In my judgment, our chances of avoiding recession in, say, 1965 would be enhanced by a period of moderate growth in 1964 and would be imperiled by a spurt of activity. Moderate growth from current high levels would be our best insurance against recession.

Fundamentally the whole debate over policy comes down to a question of how to reduce unemployment. Without underestimating the importance of the relationship between aggregate demand and employment, it must be recognized that it is not the same at all levels of employment and not the same for all compositions of the labor force. It is one thing in a situation like the 1930's; it is another thing altogether in the 1960's. And the relationship is a very special one when a large fraction of those unemployed are concentrated regionally in areas affected by selective weaknesses in demand or by especially high production costs, and when, as in the present situation, large fractions of the unemployed are unskilled workers, teenagers seeking their initial employment, or married women seeking only part-time work. My dispute with the aggregate demand solution to unemployment is that it takes an essentially nonselective approach to a problem which is present circumstances is essentially selective. Admittedly, policy should be a blend of general and selective measures. But I believe that our major emphasis at this time should be on selective measures. Aggregate demand stimulation may be appropriate in periods of actual recession or early recovery; but currently the need is for more sophisticated approaches.

The character of the selective measures that may be helpful in the reduction of unemployment are becoming increasingly familiar.

First, we need more imaginatively designed, better administered, and more generously financed programs of training, retraining, job counseling, and job placement. Our problem is not so much to lift demand by artificial measures as it is to lift to the levels required in an advanced industrial economy such as ours the individual productive capabilities of those who have difficulty finding or holding jobs.

Second, I realize that we have had difficulties in achieving constructive results from programs aimed at the development of industry in so-called distressed areas, but we must find an answer to this problem. When it is found I am sure we will see that no matter how well these programs are financed, and I favor their being financed generously, they have little chance of yielding benefits that will last and little chance of avoiding waste unless there is close participation in them on the part of the communities themselves.

Third, let us acknowledge that discrimination based on color is and continues to be, shameful as this is, a major factor in the residual unemployment problem. We have simply got to do better, and do it fast.

Finally, we know that the employment problem in the second half of the 1960's will be primarily one of creating opportunities for young men and women who will be seeking their first jobs. This will be a task primarily for American industry. It will not be an easy one. With this in mind, I hope that ways and means will be found by which our private enterprise system can approach the youth employment opportunity problem aggressively and on a concerted basis A Businessmen's Committee for Tax Reduction in 1963 is all right; but what we need right now is a Businessmen's Committee for Job Opportunities for America's Youth.

Aggregate demand will help, but it can be no substitute for success in these more selective approaches. It makes no sense to look for miracles. But it is not miracles that we need. What we need is steady, nonreversible progress in fitting individuals for jobs and into jobs. A combination of Federal expenditure, debt management, and monetary policies such as I have outlined, accompanying tax reduction, would seem to me best suited to extend the growth of our economy through 1964, into 1965 and beyond. And in this policy context I believe that selective approaches along the lines I have described, rather than still further pressure on aggregate demand, offer our best hope for success in meeting the increasingly exacting problem of reducing unemployment.

PETERSON-POLINO & ASSOCIATES,
Orlando, Fla., November 26, 1963.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: In regards to the proposed capital gains tax on the increased value of an estate at a man's death, may I present my position on this matter. This provision has been suggested as a means of unlocking properties which are otherwise held in an estate until death in order to avoid the capital gains tax. The theory put forth has been that if the property is also taxable at death, it will no longer be held until death to avoid this tax.

As it stands now, a man must pay ordinary income tax; capital gains tax, if he sells the property during his lifetime; and Federal estate taxes at his death. He may also have to pay corporation income tax so that it is conceivable that a man is taxed four times and this frequently happens. If the Federal Government really wants to unlock these properties during a man's lifetime, what they should do is to provide a credit for capital gains taxes paid during his life against the Federal estate tax at his death.

Capital gains is a tax on principal and what the Treasury Department is calling a loophole, is no loophole at all. An older taxpayer who sells a piece of property and pays a substantial capital gains tax only to die a few years later, has the same property fully taxed again. This is the height of injustice in our tax laws.

True, there is a $60,000 Federal estate exemption and the property coming under that sum escapes the Federal estate tax and receives a new basis to avoid capital gains. The honest remedy for this situation is not to compound an evil but to honestly lower or remove the Federal estate tax exemption.

I sincerely recommend that Senator Gore's proposal of imposing capital gains at death be defeated and that credit be given for capital gains paid during life against Federal estate taxes. Thank you kindly for your consideration of this matter.

Sincerely,

W. H. PETERSON.

STATEMENT OF KENNETH B. SPRAGUE, VICE PRESIDENT, AMERICAN & FOREIGN POWER CO., INC.

Mr. Chairman, and members of the committee, I am Kenneth B. Sprague, vice president of American & Foreign Power Co., Inc. We are a domestic corporation with electric operating subsidiaries in Brazil, Chile, Ecuador, Venezuela, Costa Rica, Guatemala, and Panama, and nonutility investments in Argentina, Mexico, Colombia, and India. Since 1923, my company through its subsidiaries has engaged principally in the business of supplying public utility services in Latin American countries as well as China and India. Our company has been one of the two largest investors of private U.S. capital in Latin America.

The purpose of my appearance here today is to urge you to include in any tax bill reported by your committee amendment No. 333 to H.R. 8363, submitted by Senator Long of Louisiana on November 27, 1963. This amendment No. 333 would permit a taxpayer realizing a loss as a result of expropriation of property by a foreign government to claim such loss as a net operating loss deduction over the succeeding 10-year period; and, to the extent feasible within the framework of the Internal Revenue Code, upon recovery of a foreign expropriation loss, to pay the tax that he would have paid had the loss not occurred.

My company has had a good deal of experience with foreign expropriation losses. We have suffered such losses under the Peron government of Argentina, the Communist government of China, the Castro government of Cuba, and some of the state governments in Brazil. In Cuba alone, the investment of my company's U.S. subsidiary in properties which were expropriated by the Castro government in 1960 exceeded $256 million.

Although the present tax law permits a taxpayer to claim a deduction for losses incurred as a result of expropriation, intervention, or confiscation of property by a foreign government, the period over which such loss may be utilized for tax purposes is inadequate.

Under existing law, a net operating loss incurred in 1 taxable year may be utilized during an 8-year period which includes the 3 years preceeding the loss year and the 5 succeeding years. Although the existing period is generally adequate to deal with operating losses which occur in the life of a company, it is inadequate for taking into account a loss attributable to the confiscation of property by a foreign government where such loss is unusually large. This is often the case when a U.S. company's entire foreign operations are seized.

Since there is no doubt, based upon legislative history, that the net operating loss provisions are intended to alleviate hardship by giving the taxpayer the benefit in good years of losses sustained in poor years, it would appear appropriate to modify these existing provisions so as to permit expropriation losses to be taken fully into account. Failure to give full recognition to such losses results in discrimination in favor of taxpayers with losses that are relatively small in comparison with their normal incomes as contrasted with taxpayers which suffer foreign expropriation losses that may be very large in comparison with their normal incomes.

This result, which we believe is unintended, certainly is not justified. The taxpayer himself is an involuntary victim of the foreign government's seizure. He can appeal to the U.S. Government to prevent a threatened seizure, but you are all aware of the instances where this has been of no avail. Where the U.S. Government is not in a position to prevent such overt acts, some added tax recognition should be given, especially where U.S. investments in less developed areas are being urged as a national policy of the U.S. Government.

In the case of my company, the loss arising as a consequence of confiscation in Cuba by the Castro government cannot be absorbed within the 8-year period allowed under present law. We hope that it could be fully utilized during the carryover period proposed in amendment No. 333.

Failure to allow full utilization of foreign expropriation losses for tax purposes discourages investments in less developed countries. This is contrary to the basic objective of developing such countries under the Alliance for Progress

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program which, as repeatedly pointed out by President Kennedy, Secretary Hodges, and others, must be supplemented by private investment if it is to be successful. The impact of private investment in Latin America may be illustrated by the fact that since World War II we have invested over $700 million in electric power facilities in Latin America, over half of which represented exports of electric power equipment, etc., manufactured in the United States and purchased from U.S. companies.

The amendment intended to be proposed would alleviate somewhat this existing tax inequity by permitting the taxpayer to make an election as to whether he would utilize a foreign expropriation loss over the 8-year period not provided under existing law by means of a 3-year carryback and a 5-year carryover or to utilize such loss by carrying it over for a 10-year period of time. The opportunity to use the loss solely as a carryover is particularly helpful to companies operating in less developed countries which may not have had a record of profitable years to which a net operating loss may be carried back or where they had other extraordinary losses in such period. These companies must hope to recoup their losses from future operations.

It is noted that H.R. 8363, as passed by the House of Representatives, removed the limitation on the number of years to which a capital loss might be carried in the case of an individual. Accordingly, capital loss carryovers would be available as offsets against income in subsequent years without any time limitation. In 1962 Congress extended the number of years over which a net operating loss may be carried from 8 years to 10 years in the case of taxpayers affected by the Trade Expansion Act of 1962, Public Law 87-794, and in the case of regulated transportation corporations suffering unusual losses, Public Law 87-710. In the former case, carryback of 5 years and carryover of 5 years was allowed; in the latter, carryback of 3 years and carryover of 7 years was permitted. I believe there are equally good reasons to extend to 10 years the period for utilization of net operating loss carryovers in the case of corporations which suffer foreign expropriation losses.

In addition, and somewhat similar to the tax treatment presently accorded war loss recoveries, amendment No. 333 would provide that in the event of the recovery of a foreign expropriation loss the taxpayer would, to the extent practicable within the framework of the Internal Revenue Code, pay substantially the tax that would have been paid had the loss not occurred. Further, that part of the recovery either in the form of obligations of a foreign government or the return of the expropriated physical property would be taxed over the same period of years that the foreign expropriation loss was deducted. Therefore, as nearly as may be, the taxpayer would be restored to the tax position that he would have been in had he not sustained a foreign expropriation loss.

These provisions would remedy several serious inequities under the present law. For example, under the present law a taxpayer who suffers a foreign expropriation loss may be required to use such loss to reduce income upon which no U.S. income tax would have been paid because it would have been offset by foreign tax credits. Nevertheless, upon the recovery of this portion of the loss, the taxpayer must include such recovery in income under the present law. As a consequence, the taxpayer may be required to pay a tax greatly in excess of that which would have been paid had the loss never occurred. Further, under the present law it appears that even though the foreign expropriation loss may be used to reduce capital gains, upon recovery of such loss the recovery is taxed as ordinary income. Here again, the taxpayer may be required to pay a tax substantially in excess of that which would have been paid had the loss never occurred.

It is particularly important to allow a taxpayer to pay his U.S. income tax on a recovery over a period of years where the recovery is in the form of bonds of a foreign government or consists of a return of the expropriated property. In neither case would the taxpayer have the dollars to pay the tax in the year in which the recovery is obtained unless the cash was available from some other source.

Under amendment No. 333 intended to be proposed by Senator Long the taxpayer would be given an opportunity to pay part of the tax out of payments of principal and interest received on the Government bonds. Hence, he would not be required to dispose of part of such bonds immediately to raise cash in a market

that might well be seriously depressed, assuming there would be some kind of a market and such bonds were negotiable. The taxpayer recovering properties in a deteriorated condition would be faced with a severe financial problem if required to pay the U.S. income tax in the first year of recovery while at the same time restoring the property to good operating condition. Permission to spread the tax payments over a period equal to the period in which the loss was deducted would give the taxpayer some opportunity to operate the properties and obtain cash with which to pay his U.S. income tax.

Although it may not be proper to characterize the expropriation of U.S. property by foreign governments as a common occurrence, it is submitted that the number of such foreign expropriations which have occurred in the last 18 years justifies the addition of new permanent code provisions such as those proposed in the amendment dealing specifically with foreign expropriations. In this respect, it is of interest to note that in a letter dated May 7, 1962, to Hon. J. W. Fulbright, chairman, Committee on Foreign Relations, U.S. Senate, from Mr. Frederick G. Dutton, Assistant Secretary of the Department of State, it was pointed out that since the end of World War II the following foreign governments have expropriated property of U.S. citizens: Yugoslavia, Poland, Czechoslovakia, Bulgaria, Rumania, Hungary, Communist China, Bolivia, Guatemala, United Arab Republic, Argentina, Brazil, Cuba, and Mexico.

Since, in general, expropriations by foreign governments of entire U.S. foreign investments on an industrywide basis result in substantial and unusually large losses which are not adequately provided for under existing code provisions, the amendment intended to be proposed relating to an extended period of time over which such losses may be utilized for Federal income tax purposes, as well as the tax treatment to be accorded the recovery of such losses when realized, would appear to be fully warranted.

We know that this committee is concerned, and properly so, with the impact of any proposed tax amendment on the revenue. It is, however, difficult to estimate with any reasonable degree of accuracy the revenue loss to the Federal Government which would occur if the code were amended in the manner to be proposed. Nevertheless, it is our belief that any loss of revenue will not be significant, particularly when it is noted that the proposal will only increase by 2 years the period in which foreign expropriation losses may be deducted under present law. In addition, any revenue loss which would be incurred as a result of allowing a tax deduction over the proposed 10-year period, as contrasted with the 8-year period, may be reduced by the fact that upon recovery of such loss, income will be realized to the extent that such prior loss has resulted in reducing Federal income tax in earlier taxable periods. In this respect, a foreign expropriation loss differs from the usual tax loss arising from unprofitable operations which by its nature cannot result in a recovery upon which a tax will be paid.

In any large business organization, tax planning is an integral part of corporate and fiscal planning which must look forward at least 5 years and in some cases 10 years. This is particularly so in my company's case where we have large debt maturities coming up and a constant need for plant expansion to keep up with the increasing demand for power. While we have no crystal ball to tell us when, if ever, we may recover our properties in Cuba which were valued in the neighborhood of $256 million, we must give a lot of thought to the problem and the U.S. tax consequences of such a recovery. A recovery would be most welcome, but I must say to you that the tax consequences would be staggering if we were required to pay U.S. income tax on the total recovery within a year of such reacquisition. It is therefore of the utmost importance that Congress clarify the law so that the amount of the potential tax exposure on recovery shall not substantially exceed the tax reduction on the loss and also to provide us with sufficient time to find cash to meet the tax obligation.

Finally, since the amendment intended to be proposed by Senator Long would not, in our opinion, have a substantial adverse effect on the revenue, and since such amendment would result in a more equitable income tax system, we strongly recommend, and sincerely hope, that amendment No. 333 will be included in the tax bill reported by your committee.

STATEMENT OF NATIONAL COAL ASSOCIATION, WASHINGTON, D.C., SUBMITTED BY BRUCE O'BRIEN, GENERAL COUNSEL

Mr. Chairman, the National Coal Association has in its membership producers and marketers of more than two-thirds of the Nation's commercial bituminous coal.

The position of the bituminous coal industry with respect to the proposed tax reduction bill was set forth at length, with supporting detail, before the Ways and Means Committee, and appears at pages 3543–3623 of part 7 of the Ways and Means hearings on the President's 1963 tax message. Because our position has not changed, we will not burden this record with repetition of that statement, but we do want to incorporate by reference only the statement and testimony which was presented to the Ways and Means Committee.

For ready reference, we summarize here the coal industry's position with respect to those provisions of H.R. 8363 which are of primary interest to the industry.

TAX REDUCTION

The coal industry supports the proposed reduction in tax rates. The industry believes that existing rates are beyond the point of diminishnig returns and should be reduced to permit economic expansion which will in turn generate increased revenues. The industry believes that fiscal integrity can and should be maintained without making the tax reduction conditional on reduced spending, because the stimulating effects of the reduction would be minimized by uncertainty attendant upon statutory contingencies.

EFFECT OF INVESTMENT CREDIT ON BASIS

The coal industry supports the provisions set forth in section 202 of H.R. 8363. That section repeals the requirement that the basis of property be reduced by the amount of the investment tax credit. The industry believes the adoption of section 202 will increase substantially the stimulating effect of the investment tax credit and will make an important contribution to the modernization of equipment.

DEDUCTIBILITY OF EXPLORATION EXPENDITURES

Amendment 204, proposed by Senator Gruening and others, would remove the existing limitations on the deductibility of expenditures made in exploring for minerals other than oil and gas. The coal industry urges the adoption of this provision, because an abundant supply of low-cost minerals is essential if this Nation is to maintain a dynamic and expanding economy.

With the development of new methods of exploration, the search for minerals has become a very expensive operation. The burro, the pick and the shovel have been replaced by geological and geophysical surveys, costly diamond drilling, and other expensive activities to gather the information necessary for finding the needed minerals. These expenditures correspond to the research expenditures of other industries. Like those research expenditures, mineral exploration expenditures should be completely deductible.

RECAPTURE OF DEPRECIATION ON REAL PROPERTY INVOLVING MINING

When depreciation is deducted on mining property, the deduction reduces the net income from the property which limits the percentage depletion allowance. Recognizing that full recapture of such depreciation would discriminate against the mining industry, Congress provided for an equitable adjustment—restoration to net at the time of recapture—in the case of recapture of depreciation on personal property involved in mineral extraction. This adjustment, contained in the penultimate sentence of section 613(a) of the Internal Revenue Code, should also be provided with respect to the proposed recapture of depreciation on real property.

CONTINUATION OF DEPLETION PROVISIONS WITHOUT CHANGE

The coal industry is pleased that the House rejected recommendations to increase the tax burden on the mineral industries by requiring carry forward of deductions until they reduce the "taxable income from the property" and by

partial repeal of the capital gains treatment of gain from the sale of mineral properties. For the reasons set forth in our presentation before the Ways and Means Committee, we feel that the Senate should follow the House action with respect to these items.

CAPITAL GAINS TREATMENT OF COAL ROYALTIES

The National Coal Association supports continuation of the treatment of gain from coal royalties as capital gain, without special classification.

CAPITAL GAINS TREATMENT OF IRON ORE ROYALTIES

The commercial coal producers do not oppose extension of the capital gains treatment to iron ore royalties. Most of the members of the National Coal Association are also members of the American Mining Congress, but as the chairman of the AMC Tax Committee made clear during his testimony, the commercial coal producer representatives on the AMC Tax Committee voted against the proposal to have the Mining Congress oppose capital gains treatment of iron ore royalties.

EXPENSING OF FACILITIES TO ABATE WATER AND AIR POLLUTION

The National Coal Association heartily endorses the amendment offered by Senator Ribicoff and others to permit expensing (rather than capitalizing and depreciation) equipment to prevent water and air pollution. The installation of such equipment is of primary benefit to the public and the community. Immediate writeoff of the cost thereof should be permitted, as is the case with respect to other contributions for the public benefit.

STATEMENT ON H.R. 8363 BY JOHN R. GREENLEE, CHAIRMAN, NATIONAL AFFAIRS COMMITTEE, AMERICAN IRON ORE ASSOCIATION

The American Iron Ore Association is a trade association representing companies which mine over 94 percent of the iron ore produced in the United States and Canada. The association headquarters is located at 600 Bulkley Building in Cleveland, Ohio.

This statement is submitted on behalf of the National Affairs Committee of the American Iron Ore Association for the purpose of directing the attention of the Finance Committee of the U.S. Senate to certain changes proposed by H.R. 8363, which directly relate to the iron ore mining industry and the studied recommendations of the association with respect thereto.

The sound long-term growth of our economy can best be achieved by placing more emphasis on the kind of tax reduction that will materially reduce the deterrents inherent in the present rate structure. If the country is to move forward he investment sector of our economy must be stimulated and encouraged, and intense efforts must be made to control and reduce Government expenditures.

As a general observation, we feel that too much stress has been placed on the increase in mass purchasing power. The rate structure reform contained in H.R. 8363 as it passed the House of Representatives does make important reductions in individual rates. However, these reductions are accompanied by an increase in the steepening in the rate progression in the middle brackets over those that exist under present law. The association believes that a reduction in the individual rate progression along with a substantial reduction in the corporate income tax rates would be desirable.

Specifically we direct the committee's attention to the following items as they relate to the iron ore mining industry:

UNLIMITED DEDUCTION FOR EXPLORATION EXPENDITURES

Section 616 of the Internal Revenue Code of 1954 which has been substantially unchanged since its original enactment as section 23(cc) of the 1939 Internal Revenue Code provided that mine development expenditures may be deducted when incurred.

Section 615 of the Internal Revenue Code of 1954 provided that exploration expenditures in an amount not to exceed $100,000 per year for each of 4 years could be deducted. Public Law 86–594 (H.R. 4251), which became law on

July 6, 1960, revised section 615(c) to provide that each taxpayer would be allowed a lifetime total of $400,000 as deductible exploration expenditures.

Section 615 of the Internal Revenue Code defines exploration expenditures as "expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development state of the mine or deposit." Section 616(a) defines development expenditures as "all expendtiures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed."

The law and regulations clearly distinguish the cutoff point between the exploration stage and the development stage of a mine, but field practice of the Internal Revenue Service has been to improperly construe the cutoff point. Many actual development expenditures have been classified by the Internal Revenue Service as exploration expenditures although incurred after the disclosure of "ores or minerals in commercially marketable quantities."

The efforts of the iron ore mining industry are increasingly being directed to the development of low-grade natural ores and the beneficiation and agglomeration of these ores into a commercially acceptable high-grade product. This fact is inevitably increasing the area of controversy arising from differences in interpretation as to the cutoff point between exploration and development. In addition, exploration expenditures per se represent an increasingly important part of necessary research activity of the iron ore mining industry and should be encouraged.

The American Iron Ore Association urges that your committee remove the limitations on the deduction of exploration expenditures contained in present law and thereby—

(1) Provide an incentive for the increase of exploration and related research activity by the mining industry; and

(2) Resolve the conflict existing with respect to interpretation of present law as it relates to the determination of the cutoff point between exploraion expenditure and development expenditure.

INTEREST ON CERTAIN DEFERRED PAYMENTS

Section 215 of the House bill proposed to add to the Internal Revenue Code new section 483 which attributes interest as an element of certain deferred payments. The application of this proposed statutory concept in the area of payments that are indefinite as to term, liability, or amount is unsound and unworkable.

An example of this type of payment of particular interest to the mining industry is the well-settled method of making capital payments for mining properties by a series of non-interest-bearing notes coming due in the future at the times when the mineral is expected to be mined. No interest is ever expected on future royalty payments and likewise no interest payments are expected on capital payments for mines.

An undesirable feature of section 215 is that the measurement of the acceptable rate of interest is left to the caprice of the Internal Revenue Service with the probability of different rates being used each year.

CURRENT TAX PAYMENTS BY CORPORATIONS

Section 122 of the proposed bill provides for the transitional speedup of corporate income tax liabilities.

Corporations are vastly more complicated taxpaying entitites than are individuals as a general rule. Estimating the amount of taxable income that will be earned in a particular year so far in advance, at least, with any precision, will be extremely difficult. This is particularly true in a business as seasonal as iron ore mining.

If a corporate payment speedup provision is finally adopted, we strongly urge that the first installment be deferred until the 15th day of the 5th month of the taxable year and, that the requirements that 70 percent of the liability in excess of $100,000 be paid currently to avoid penalty, be reduced to 50 percent. These changes would at least permit the use of first quarter figures for the estimated first installment payment and the reduction of the penalty test computation per-

centage from 70 percent to 50 percent would mitigate to some extent the estimating problems inherent in a business as seasonal as the iron ore mining business.

TREATMENT OF CERTAIN IRON ORE ROYALTIES

Section 218 of H.R. 8363 proposes an amendment to section 631(c) of the Internal Revenue Code of 1954 which, if adopted, would extend capital gains treatment to royalties received by the lessors of iron ore properties. Capital gains treatment of iron ore royalties as proposed by section 218 is an unwarranted modification of the Internal Revenue Code. While in the case of other natural resources such treatment of royalties may be an incentive to the producing industry, this is not the case with respect to iron ore. Iron ore producing companies are not in need of this provision for the stimulation of production as it would have no beneficial effect on their cost of production. More appropriate incentives to greater production of iron ore would be liberalization of deductions for exploration and the adoption of a proper tax cut.

We appreciate this opportunity to submit these comments for your consideration.

IDAHO MINING ASSOCIATION,
Boise, Idaho, December 3, 1963.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: According to news reports this week, the Senate Finance Committee will consider on Wednesday, December 4, the proposal by Senator Ernest Gruening and several cosponsors to amend the tax reduction bill (H.R. 8363) to abolish the existing limitations on deductibility of mineral exporation expenditures in determining income tax liability.

The Idaho Mining Association takes this means of recording its strong endorsement and support of this amendment. In the mining industry, exploration is the basic research by which an operator seeks to maintain and improve his competitive position in the marketplace. Present limitations with respect to deductibility of such exploration costs are not only completely unrealistic in terms of today's inflated costs of operation, but also highly inequitable and discriminatory in that they deny to the mining industry the same type of tax treatment that is accorded the research outlays of other industrial enterprises.

We wholeheartedly concur in the policy statement on taxation of the American Mining Congress which reads, in part, as follows:

"Exploration expenditures, like other research expenditures, should be fully deductible and present limitations on deductibility of exploration expenditures shold be removed."

We would greatly appreciate having this incorporated in the hearing record, if committee policy permits.

Respectfully submitted.

A. J. TESKE,
Secretary, Idaho Mining Association.

BLUE GOOSE GROWERS, INC.,
Fullerton, Calif., December 4, 1963.

Re H.R. 8363, revenue bill of 1963, section 220 (code sec. 1250), gain from dispositions of certain depreciable realty.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Blue Goose Growers, Inc., is a harvester, packer, and marketer of fruits and vegetables in various areas of the United States, including California and the west coast, Texas, Georgia, South Carolina, Florida, Delaware, Virginia, West Virginia, Maryland, and Pennsylvania. In the latter three areas, our affiliated corporation is the owner of 2,900 acres of apple and peach orchards known as the Dillon and Trexler properties. In the other areas, we own or own interests in citrus and decidous orchards and vineyards and do the packing and marketing for hundreds of smaller orchard owners. As such, we directly and through our customers have a vital interest in the provisions of the Internal Revenue Code concerning gain realized upon the sale of depreciable property.

We are deeply distressed because of the presence in the Internal Revenue Code of section 1245, which requires that in the case of sale of depreciable property other than buildings, gain realized must be treated as ordinary income rather than long-term capital gain to the extent of depreciation taken after 1962. H.R. 8363, the 1963 bill, proposes a different and much fairer provision with respect to building, the conception being that gain from the sale thereof will be treated as ordinary income only to the extent of additional depreciation—that is, the rapid portion in excess of straight-line depreciation—taken after 1963, and only fractionally on a diminishing basis down to no adjustment at all after 10 years of ownership.

The explanation of the House Ways and Means Committee for this gentler treatment of building gain is summarized in the following paragraph from the general explanation of the Ways and Means Committee Report (see pp. 102–103 of CCH Special No. 4, Sept. 17, 1963):

"Your committee generally has limited the depreciation recapture to the excess over straight-line depreciation because it believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other forms of gains which quite generally are treated as capital gains. Moreover, your committee believes that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation deductions. For that reason, your committee's bill also tapers off over a 10-year period the proportion of the additional depreciation (or gain where smaller) which is to be treated as ordinary income upon the sale of the property."

The writer has discussed this provision with tax counsel and with many businessmen and farmers, and has given considerable thought to its impact upon manufacturing, service, and farming business. I am convinced that section 1245, as now written, is fundamentally inconsistent with section 1250 as proposed; that it is unfair to deserving branches of the business and farming community; and that unless it is appropriately amended, it will have a seriously disturbing and retarding effect upon the very business improvement which is so much the concern of Congress in the 1963 revenue bill.

My advisers and I are convinced that if rapid depreciation is left out of account, the reason for gain from the sale from any depreciable property, as a general proposition, will be exactly what the Ways and Means Committee said it is for buildings, that is, "attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property." This is certainly true of such depreciable property as orchards, pipelines, and concrete ditches, irrigation and drainage equipment, farm machinery and packinghouse machinery and equipment, in which our company and its customers are so vitally interested.

In this regard, I am enclosing a reprint of an article which appeared in the March 1963 issue of "Taxes," entitled "Capital Gain Treatment Should Be Restored for Depreciable Business Property,"[1] written by a prominent Los Angeles tax attorney.

It would be a sound approach to eliminate section 1245 from the code, and section 1250 from the 1963 revenue bill. But if section 1250 is to be enacted, then fairness and the congressional objective of business encouragement require amendment of section 1245 to make its provisions consistent with those of section 1250. Section 1245, also, should apply only to "additional" (i.e., the rapid portion) of depreciation taken, and the adjustment should taper off over a 10-year period.

The writer believes that the soundness of this approach would not be seriously disputed in either the House Ways and Means Committee or in your committee; and that the present form of the House bill, which does not attempt amendment of section 1245, is the result of lack of sufficient time for consideration and study.

Your attention to this matter will be sincerely appreciated. Copies of this letter and of the enclosure are going to the other members of the Finance Committee.

Very truly yours,

W. THOMAS DAVIS, *President.*

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[1] The information referred to is retained in the committee files.

STATEMENT SUBMITTED BY E. S. WEISE, JEWELL, IOWA

PROMOTE OWNERSHIP OF FARMLANDS INTO THE HANDS OF YOUNG OPERATORS THROUGH FHA

The world over, since the children of Israel received an inheritance and "sat every man under his fig tree," every tiller of the soil's inherent desire is to operate his own land. Ancient heros were honored and awarded parcels of land for deeds of valor—"Horatius."

One hundred years ago this august body brought into being the Homestead Act, it was one of the factors that made this them ightiest nation on earth.

Family farmownership has become generally accepted as a cornerstone of American land policies, it is the top rung on the agricultural ladder."[1][2]

The fulfillment of this ambition would make for a healthy community, real aid for small business and strengthen the national agricultural economy. The Farm Security Administration's "tenant purchase program" under the Bankhead-Jones Farm Tenant Act was a step in the right direction; however, it is limited in that now the Farmers Home Administration can only buy the poorest of farms especially in the grade A land areas because of price restrictions and lack of funds. Due to these restrictions plus size of operation the Farmers Home Administration has perpetuated some submarginal farmers and reduced others to that level, more latitude by the State FHA director is sorely needed.

The agricultural ladder is broken, all the lower rungs are missing, no longer can a youth progressively become a hired man, tenant farmer, contract owner, then a full owner. In this area you can count the number on your fingers that have reached the ownership goal by this method in the past 10 years. The average tenant farmer's life is too short to ever accumulate the increasing amount necessary for down payment toward the purchase of a farm.

"By this method in the past 10 years only 7 percent have reached the ownership goal, 71.1 percent of all farm transfers were on the woman's side of the family."[2]

Does not this indicate we are drifting into the old feudal system?

Our ancestors left the old country's "baronial estates" to help build anew here with opportunity for everybody. Why should we now employ strong arm methods to reconstitute a modernized feudal system where again ownership is through marriage or inheritances and succession to dynasty is by birthright? Are we not establishing an absolute "closed shop landed aristicracy" via economic measures? This being the case by what "divine right" are we (nation) instituting and/or advocating "land reform" in foreign countries if we create here the very thing we are "foreign aiding to correct elsewhere"?

Some are in an economic vise from which they cannot free themselves. This is especially true of veterans and others that started farming in 1949 and during the Korean conflict; because he must produce 2 bushels in order to have 1 for himself, 50 percent going as rental (Cornbelt) while the increased costs are his. It is common knowledge that the price squeeze in this direction has increased tremendously, there is a crying need to help young farmers become owner-operators.

"Freedom from want at home and throughout the world is attainable; the scientist offer proof of this. But it can be attained for the long run only if all forces concerned with human welfare unite in common objective—farm home ownership, or its equivalent, by those who till the soil."[3]

Contrary to the generally accepted idea that 75 percent of the farmers are owner-operators, we find that Iowa (recognized by and large as one of the greatest agricultural areas in the world), is not in that bracket. "Farmownership by operators increased gradually from a low point of 41 percent of farmland in 1933–35 period to a high of 50 percent in 1952."[4]

Nine percent is not much of an increase when viewed in light of the vaunted prosperity on the national basis. A further check into the facts on the county level reveals that Calhoun County has the dubious honor of having 71.1 percent

[1] Family-size farm: The size depends on the locality, the crops produced in that area and what the family can profitably operate with a minimum of hired help during peakload seasons.

[2] "Farm Ownership in the United States" by Dr. J. F. Timmons, Iowa State College, Ames, Iowa.

[3] "Town and Country Churches and Family Farming" by Dr. M. Harris and Dr. J. Ackerman.

[4] "Assessors' Annual Farm Census," 1954, p. 8.

tenant-operators, an increase of 2.6 percent from 1949 at the same time it shows an increase of $3 million in gross income from $17 million to $20 million. This county (Hamilton) has 64.0 percent tenancy, an increase of 4.6 percent from 1949 with an increase of $6,170,552 in gross income from $20,156,977 to $26,227,529 for a like period. In this area where the terrain is adaptable to four row power equipment FHA has been unable to purchase any farms. By contrast Clarke County with 36.8-percent tenancy shows a decrease of 4.2 percent and gross income of $6,798,735 to $5,951,146, a decrease of $847,589. Would you conclude that a decrease in income is conducive to ownership? During this time FHA purchased 20 farms in this county, should FHA therefore be condemned? On the contrary it is operating within the limits imposed by Congress. But why should tenant-operators in the north-central area be penalized by congressional action because land values are higher even though income indicates they could pay for a farm faster than Clarke County operators?

We are cognizant of the landlord in that he pays taxes and is entitled to interest on his investments, plus upkeep, etc.; we are not interested in "fair shares," "leveling devices" of putting "ceilings" on opportunity, or "raids" on the Treasury, rather we prefer the American way of expanded opportunity for all. Just give us the tools we will do it ourselves.

The farmer formerly retired to a local town and became a landlord living off the rentals of his land. This was his social security. The farmers that now are about to retire from agriculture have acquired these farms during the thirties or forties at an average price of $100 to $125 per acre in this area, either assisted by the moratorium and Federal land bank commissioner loans or outright purchase.

Six things prevent the sale of farm land to tenant farmers.

Sellers position:

1. Taxes: Even capital gains takes a big bite out of the sale price.
2. Restricted: Increasing asking amount for downpayment limits the number of buyers.
3. Funds: Problem of investing realized cash in a new field.

Tenants position:

1. Age: Everyone wants to protect youth from taking risks in appreciating investments but have no compunctions whatsoever from getting them into debt up to their eyebrows on expendables.
2. Cash: Actuarial statistics prove he will be dead before he can accumulate the asking downpayment by saving.
3. Credit: No private lending agency is interested in extending credit to these individuals, while "Government aid" set up for this purpose in FSA, now Farmers Home Administration, functioning these 20-odd years has been extremely limited in this direction.

Question. "How can we get tenant farmers into the owner-operator bracket and keep them there?"

Wherefore we propose—

1. The Federal Government guarantee the contract sale between seller and purchaser.
2. Authorize Farmers Home Administration to act as a credit depository.
3. Cancel capital gains tax on farms sold to qualified tenant[5] operators, and then only if the entire transaction is approved by Farmers Home Administration.

This is not a "something-for-nothing deal." To take advantage of the "no-tax sale" the seller must do two things to qualify:

(a) Accepts 10 percent (?) downpayment from purchaser, balance in form of a "guaranteed credit deposit" with Farmers Home Administration in lieu of cash.

(b) Accepts a low-interest rate the first 5 years then it graduates upward in 5-year intervals in exchange for "no tax sale," thus becoming a "landlord."

Tenant purchaser agrees:

(a) Loan insurance, not transfer farm for period of 5 years because of profit motives.

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[5] Qualified tenants—
(a) Five years farming experience.
(b) Adequate equipment and a minimum of livestock debt free.
(c) Preferably a native of the community.
(d) References, bank and three farm owner-operators.

(b) Variable payments equivalent to rentals on a crop-share basis be mandatory. This will unlock billions of private capital together with a goal for farm youth including an incentive to reach it.

Here are the mechanics: Owner sells to qualified tenant for whatever price they agree (FHA) approval), seller takes Government guaranteed deposit account with FHA in lieu of money in exchange for no income taxes on the real estate transaction; however, if the seller withdraws from this account an amount in excess of the principal payments made by the tenant-purchaser, such excess amount be subject to capital gains tax, interest earnings from this account be taxed at the regular rate. This shall in no way affect the interest payments made by the purchaser nor shall the seller be forced to withdraw any specified sum, but can leave all on deposit to accumulate interest at the lowest rate. No purchaser shall be able to sell or transfer for a period of 5 years any farm financed under any FHA plan because of profit motives. Set up on an amortized long-term basis, nominal downpayment, graduated interest rates, purchaser to make variable payments equivalent to rentals:

Example: 160-acre Midwest farm:

Owner and tenant agree (FHA approval) 160 acres, at $300 per acre	$48,000
Seller purchased or redeemed under moratorium, at $100 per acre	16,000
Capital gains tax waiver, less improvements plus depreciation on profit of	32,000

Seller accepts Government guaranteed credit deposit with FHA in amount of $48,000 less nominal downpayment by purchaser, in lieu of cash in exchange for no tax ($8,000 capital gains in this instance) it may be argued we are hereby subsidizing retirement by forgiving the tax, however; unless there is a sale no tax is due and we call your attention to the fact that another taxpayer is set up in his place from whom we expect to collect taxes during the next 30 years. Graduated interest rates in 5-year brackets, first 5 years 4 to 4½ to 5 percent until paid. This will induce the purchaser to pay off his incurred obligations to the limit of his ability at the low rate years, meanwhile discouraging the seller from overdrawing his credit deposit account due to the prospect of increased future interest earnings. These counterforces will keep the credit deposit account intact. Variable payments equivalent to rentals by the purchaser are mandatory. If it were not for this FHA assist the purchaser would be making rental payments anyway without accumulating an interest in the land he farms. For instance the average combined principal and interest payment for the first 5 years approximate $2,565 per annum, assuming the average annual income on a rental basis would amount to $4,000, the purchaser would then have a prepaid credit of $1,435 which could be applied to equalize a bad year or liquidate his obligation sooner.

After 10 years have elapsed private lending institutions will be inclined to grab off the prepaid accounts where the progressive operator has demonstrated his interest in retiring his obligation.

However should the heirs decide to withdraw the credit deposit account with FHA for purposes of settling the estate of the person that originally entered into a credit deposit account contract with FHA, then the remaining balance shall be subject to capital gains tax; but nothing shall prevent the heirs from entering into a contract with FHA to extending the balance of the credit deposit account that originally was contracted by the deceased without paying the capital gains tax.

The FHA approval prerequisite is a check for using this plan as a vehicle to inflate land prices, nor shall this be a device for transferring "sour" credit accounts from private banks and lending institutions to FHA, but rather let FHA's judgment decide whether an applicant with "thin" credit and ambition is a good long-range credit risk.

"The question may be raised why have any tenancy, particularly if 100 percent loans are workable? In other words, what are the advantages and disadvantages of substituting "lendlords" for landlords? If a significant proportion of farms continue to be tenant operated, what is the function of the landlord? In earlier years the landlord furnished both credit and management to young farmers. With large number of urban farmowners and woman landlords resulting from the operation of the laws of descent, has not the function of landlords changed materially?"[3]

Now social security is an added factor too. Therefore Farmers Home Administration assistance and management is essential.

It may be argued we are subsidizing retirement by forgiving the capital gains tax, however, unless and until there is a sale, no taxes are due, also if the owner elects to parcel it out while he is living "uncle" will not collect inheritance taxes either. The seller's ambition is spent, further social security discourages his efforts toward extra income, presently many owners of retirement age would be willing to sell on this basis.

Tax revenue:

1. Presently the income from tenant-operated farms is divided on a 50-50 basis and the tax proportioned subject to the deductions of the individuals affected. Under the above plan the new owner-operator will receive 100 percent of the income and pay taxes accordingly.
2. The new owner-operator will pay into his account with the FHA credit depository an amount equal to the crop share rental for that particular year, from this same account the former owner-landlord (now lendlord under FHA) will receive an amortized principal payment tax free plus an interest payment subject to the regular taxes.
3. The lendlord by this plan has a guaranteed fixed income, whereas the owner-operators income fluctuates appreciably, influenced by many factors but principally the weather therefor to make things equitable a 5-year balance on his income taxes would be in order.

Thus assume: Four out of five years he has taxable income, 1 year he operates at a loss, let him pay the regular taxes due each year as earned. The fifth year add the total income for the past 5 years, multiply the sum by the highest rate in effect in that particular 5-year period, substract the amount of taxes paid during such period. The balance will represent a refund or taxes due for the fifth year. No supplementary income in excess of 15 percent shall escape taxes through this provision.[6]

CONCLUSION

Makes taxpayers of people you will support one way or another. Provides farm youth with a goal, encourages permanent community roots. Our argument is valid, the request reasonable, the idea sound. There are secondary benefits to others too. It will influence stabilization of family farms and communities. Enables a tenant-purchaser to avail himself of long-range planning and cuts waste. Accelerates use of Farmers Home Administration already functioning. Inflation proof, makes no "raid" on the Treasury, pays its own way. (This principle will work for transferring small businesses too.)

(Whereupon, at 12:30 p.m., the committee was in recess, to reconvene at 10 a.m., Thursday, December 5, 1963.)

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[6] From statement to House Committee on Agriculture, Washington, D.C., Mar. 1, 1956: "Tighten up income tax laws so no one who does not depend upon agriculture for 85 percent of his income may use profits made in other business to cover farm losses—tomatoes are one of our crops, when prices remain around the 3- to 4-cent level farmers have no outside competition but if prices rise as this year to 12 and 15 cents then next season we have bankers, lawyers, doctors, barbers, merchants all in the tomato business from a few acres on up. They have all to gain and nothing to lose as Uncle Sam pays their losses taxwise," by Mr. J. Perrin Willis, agricultural economist and radio farm director, KTLU, Rusk, Tex.

"Calhoun, Clarke, and Hamilton Counties, dollar value of all farm products sold." (Source: U.S. Department of Commerce, U.S. Census of Agriculture: 1954, vol. 1, "Counties and State Economic Areas," pt. 9, Iowa, pp. 69 and 70.)

"Percent of owner-operated and tenant-operated." (Source: Iowa Department of Agriculture, Division of Agriculture Statistics, "Assessors' Annual Farm Census," table 5, pp. 12 and 13 for 1949 to 1954, inclusive.)

"FHA. Farm purchases 1949 through 1954, inclusive." (Source: U.S. Department of Agriculture, FHA, State office, Des Moines, Iowa.)

REVENUE ACT OF 1963

THURSDAY, DECEMBER 5, 1963

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

The committee met, pursuant to recess, at 10 o'clock a.m. in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Douglas, Gore, Talmadge, Hartke, Ribicoff, Williams, Carlson, Bennett, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

Senator WILLIAMS. I would ask, Mr. Chairman, that at the beginning of this hearing there be printed a copy of the amendment which I propose to introduce as an amendment to this tax bill.

The CHAIRMAN. Without objection.

(The amendment to bill H.R. 8363 follows:)

[H.R. 8363, 88th Cong., 1st sess.]

AMENDMENT

Intended to be proposed by Mr. WILLIAMS (Delaware) to the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes, viz: At the proper place in title II of the bill insert the following new section:

SEC. . PERCENTAGE DEPLETION RATES FOR OIL AND GAS WELLS, ETC.

(a) Section 613(b) of the Internal Revenue Code of 1954, relating to percentage depletion rates is amended

(1) by striking out "27½ percent—oil and gas wells" in paragraph (1) thereof and inserting "20 percent—oil and gas wells", and

(2) by striking out "23 percent—" in paragraph (2) thereof (relating to sulfur and uranium and certain minerals from deposits in the United States) and inserting "20 percent—".

(b) The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1963.

The CHAIRMAN. The first witnesses will be a panel composed of Mr. Harold Decker, Mr. Richard H. Gonzalez, and Mr. Wallace W. Wilson; appearing in behalf of the Independent Petroleum Association, the Mid-Continent Oil & Gas Association, the Western Oil & Gas Association and the American Petroleum Institute.

So, gentlemen, if you will sit down and proceed.

STATEMENT OF HAROLD DECKER, IMMEDIATE PAST PRESIDENT OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. DECKER. Mr. Chairman, my name is Harold Decker. I appear before your committee as the immediate past president of the Independent Petroleum Association of America, a natioal trade association representing approximately 6,000 independent oil and gas producers from all producing areas in the United States.

In the interest of time, the Independent Petroleum Association, Mid-Continent Oil & Gas Association, American Petroleum Institute, and Western Oil & Gas Association has coordinated their testimony which will be presented by a panel consisting of myself, Dr. Richard H. Gonzalez, and Mr. Wallace W. Wilson,

Furthermore, in presenting our testimony, we will summarize our presentations so that the entire testimony can be completed within 30 minutes. With your permission, I would like to file my full statement for the record and present a summary for your consideration.

The CHAIRMAN. Without objection.

Mr. DECKER. In considering Federal tax policies as to oil and natural gas production, I respectfully invite your attention to pertinent economic conditions and trends existing in the domestic petroleum industry. These conditions and trends have been summarized in the graphic chart attached to my testimony.

The chart shows trends in the U.S. oil- and gas-producing industry, and compares these trends with changing conditions in the overall U.S. economy. All factors are expressed in terms of index numbers, using the Government base period of the average for the 3 years 1957, 1958, and 1959 as equal to 100.

If you will now examine the chart, one fact becomes apparent: economic conditions in the domestic petroleum industry have deteriorated steadily while the U.S. economy in general has experienced continuing upward trends. Each factor measuring the health of the oil- and gas-producing industry has been declining. Each factor for the general economy shows advances. In short, a private petroleum recession persists despite an expanding national economy.

You will note that the total value of the output of U.S. goods and services, as measured by the gross national product, has increased by 27 percent since the 1957–59 base period, with a growth of 23.5 percent in total industrial production. In contrast, oil and gas exploration in the United States, as indicated by the number of wildcat wells drilled, is down almost 20 percent and drilling rig activity is lower by about 32 percent.

The number of employees engaged in domestic oil and gas production shows a decrease of 10.8 percent as compared with a rise of 8 percent in total U.S. nonagricultural employment. The retail price of gasoline at service stations has dropped by 6.5 percent while there has been a 4-percent advance in the overall level of consumer prices. Crude oil prices show a 4-percent decline during the period when the wholesale price of all commodities has remained above the average level for the 1957–59 base period.

Although not shown on the chart, the total value of crude oil production has been below the 1957–59 average for most of the period except for the first 9 months of 1963 when the value of production was only 4 percent above the 1957–59 average. The decline in crude oil prices acted to depress the value of production and offset the relatively small increase in crude oil output.

The declining trends in prices, employment, and activity reflect the increasingly unfavorable atmosphere for capital investments in oil and gas production. The rate of return on these investments is the true measure of profitability in the industry. It is significant that the domestic petroleum industry has a lower rate of return on invested capital than the average for all manufacturing industries, as shown in the following tabulation:

Rate of return on invested capital

[In percent]

	All manufacturing companies [1]	Petroleum companies (domestic) [2]		All manufacturing companies [1]	Petroleum companies (domestic) [2]
1955	12.6	10.2	1960	9.2	8.8
1956	12.3	10.5	1961	8.8	8.7
1957	11.0	10.1	1962	9.8	8.8
1958	8.6	7.2			
1959	10.4	8.5	Average 8 years	10.3	9.1

[1] From Federal Trade Commission-Securities and Exchange Commission.
[2] From Chase Manhattan Bank.

For the latest 8-year period from 1955 through 1962 domestic petroleum earnings averaged 9.1 percent on invested capital as compared with 10.3 percent for industry generally. The rate of return for petroleum companies was lower, not only for the entire period, but also for each of the 8 years.

Preliminary figures for the first 9 months of 1963 show that, while there was some increase in the rate of return for petroleum companies, the rate for petroleum remained below the average for all manufacturing companies.

With relatively low rates of return on investment, declining prices, shrinking employment and progressively sharp curtailment of exploration and development activities, adverse changes in petroleum tax provisions would widen the growing disparity between economic trends in the domestic petroleum industry and the general economy, I respectfully urge the committee to take no action as respects petroleum tax provisions that would weaken the Nation's strength of the supply of oil and natural gas.

(The prepared statement of Mr. Decker follows:)

TESTIMONY BY HAROLD DECKER ON REVENUE ACT OF 1963 (H.R. 8363) BEFORE SENATE COMMITTEE ON FINANCE, DECEMBER 5, 1963

Mr. Chairman, my name is Harold Decker. I appear before your committee as the immediate past president of the Independent Petroleum Association of America, a national trade association representing approximately 6,000 independent oil and gas producers from all producing areas in the United States.

The purpose of my testimony is twofold: to support, with one exception, the actions taken by the House Ways and Means Committee with regard to tax proposals relating to oil and gas production; and to present briefly for your consideration certain basic facts that show why, in the public interest, adverse changes should not be made in petroleum tax provisions.

In considering Federal tax policies as to oil and natural gas production, I respectfully invite your attention to pertinent economic conditions and trends existing in the domestic petroleum industry. These conditions and trends have been summarized in the graphic chart attached to my testimony.

The chart shows trends in the U.S. oil and gas producing industry and compares these trends with changing conditions in the overall U.S. economy. All factors are expressed in terms of index numbers, using the Government base period of the average for the 3 years 1957, 1958, and 1959 as equal to 100.

If you will now examine the chart, one fact becomes apparent: economic conditions in the domestic petroleum industry have deteriorated steadily while the U.S. economy in general has experienced continuing upward trends. Each factor measuring the health of the oil and gas producing industry has been declining. Each factor for the general economy shows advances. In short, a private petroleum recession persists despite an expanding national economy.

You will note that the total value of the output of U.S. goods and services, as measured by the gross national product, has increased by 27 percent since the 1957-59 base period, with a growth of 23.5 percent in total industrial production. In contrast, oil and gas exploration in the United States, as indicated by the number of wildcat wells drilled, is down almost 20 percent and drilling rig activity is lower by about 32 percent. The number of employees engaged in domestic oil and gas production shows a decrease of 10.8 percent as compared with a rise of 8 percent in total U.S. nonagricultural employment. The retail price of gasoline at service stations has dropped by 6.5 percent while there has been a 4-percent advance in the overall level of consumer prices. Crude oil prices show a 4-percent decline during the period when the wholesale price of all commodities has remained above the average level for the 1957-59 base period.

Although not shown on the chart, the total value of crude oil production has been below the 1957-59 average for most of the period except for the first 9 months of 1963 when the value of production was only 4 percent above the 1957-59 average. The decline in crude oil prices acted to depress the value of production and offset the relatively small increase in crude oil output.

The declining trends in prices, employment, and activity reflect the increasingly unfavorable atmosphere for capital investments in oil and gas production. The rate of return on these investments is the true measure of profitability in the industry. It is significant that the domestic petroleum industry has a lower rate of return on invested capital than the average for all manufacturing industries, as shown in the following tabulation:

Rate of return on invested capital

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1957	11.0	10.1
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1959	10.4	8.5
1960	9.2	8.8
1961	8.8	8.7
1962	9.8	8.8
Average, 8 years	10.3	9.1

[1] From Federal Trade Commission-Securities and Exchange Commission.
[2] From Chase Manhattan Bank.

For the latest 8-year period from 1955 through 1962, domestic petroleum earnings averaged 9.1 percent on invested capital as compared with 10.3 percent for industry generally. The rate of return for petroleum companies was lower, not only for the entire period, but also for each of the 8 years. Preliminary figures for the first 9 months of 1963 show that, while there was some increase in the rate of return for petroleum companies, the rate for petroleum remained below the average for all manufacturing companies.

With relatively low rates of return on investment, declining prices, shrinking employment, and progressively sharp curtailment of exploration and development activities, adverse changes in petroleum tax provisions would widen the growing disparity between economic trends in the domestic petroleum industry and the general economy. In the final analysis, the Nation's economic progress, which is related to the availability of low-cost energy supplied primarily by oil and natural gas, would be impeded. Transcending all else, the security of the United States would be threatened by weakening the Nation's strength as to essential petroleum supplies. With oil the principal weapon in the Soviet economic offensive, it would seem foolhardy indeed to exchange the hope of additional tax dollars for the certainty of adequate U.S. oil and gas supplies.

For the foregoing reasons, we support the action by the House Ways and Means Committee in rejecting two recommendations by the Treasury Department that were of great concern to independent producers. One of these proposals would have required the carryover of certain losses in computing percentage depletion. The other would have taxed as income, rather than capital, the gain, or a portion of the gain, realized in the sale of oil and gas properties. The net effect of these two proposals would be to reduce substantially the amount of depletion and impose on producers an additional tax burden estimated initially by the Treasury Department as amounting to about $250 million annually. Any such action would have a severe impact on the independent producers who play a vital role in the drilling of exploratory and development wells that find and make available the new reserves to meet the growing requirements of the future. Depressed conditions in the domestic producing industry would be aggravated, and the industry would fall further behind in its efforts to keep pace with the expansion of the general economy. Therefore, we earnestly urge your committee to reject any effort to incorporate in the bill these recommendations or any other proposals that would further depress the essential function of developing U.S. oil and gas resources. For these same reasons, it seems to us that the provision in section 217 of the bill pertaining to the aggregation of oil and gas properties should be eliminated. Other witnesses on this panel will discuss the technical aspects of this provision. I would only suggest that conditions in the industry are such that any additional taxes derived from this provision will drain further the funds for exploration and drilling.

The evidence I have presented shows that one of the Nation's basic industries—oil and gas production—is in a declining and depressed economic condition. This industry is an important segment of our national economy, as illustrated by the fact that the value of oil and gas production exceeds the combined value of all other minerals produced in the United States. Petroleum production is vital to the economic life of more than half of the States and thousands of communities. Domestic energy sources provide the fuels for our industrial economy and act as a powerful deterrent to war. I respectfully urge your committee to take no action as to petroleum tax provisions that would weaken the Nation's strength as to its supplies of oil and natural gas.

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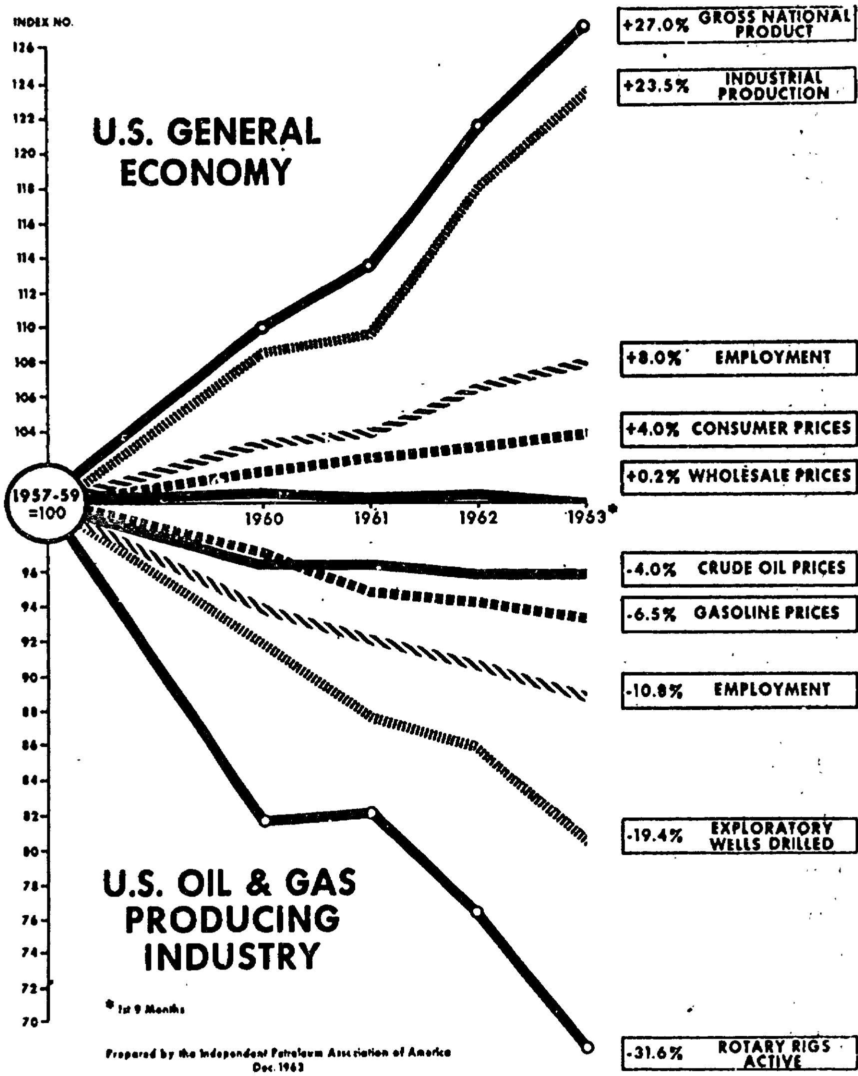
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U.S. GENERAL ECONOMY
1957-59 =100
1960
1961
1962
1963*
+27.0% GROSS NATIONAL PRODUCT
+23.5% INDUSTRIAL PRODUCTION
+8.0% EMPLOYMENT
+4.0% CONSUMER PRICES
+0.2% WHOLESALE PRICES
-4.0% CRUDE OIL PRICES
-6.5% GASOLINE PRICES
-10.8% EMPLOYMENT
-19.4% EXPLORATORY WELLS DRILLED
-31.6% ROTARY RIGS ACTIVE
U.S. OIL & GAS PRODUCING INDUSTRY
* 1st 9 Months
Prepared by the Independent Petroleum Association of America
Dec. 1963

U.S. general economy and U.S. oil and gas production

1957-63

	Unit	Average, 1957-59	1960	1961	1962	1963, 9 months
General economy:						
Gross national product (GNP)	Billion	$456.7	$502.6	$518.2	$554.9	[1] $580.0
Employment (nonagricultural)	Million	58.9	60.9	61.3	62.7	[1] 63.6
Oil and gas production:						
Crude oil prices	Barrel	$3.10	$3.00	$3.00	$2.98	$2.98
Gasoline prices (service station, excise tax).	Cents per gallon	21.6	21.0	20.5	20.4	20.2
Employment	Thousand	334.1	318.9	308.8	304.0	[1] 298.1
Exploratory wells drilled	Number	10,466	9,635	9,191	9,003	8,435
Active rotary drilling rigs	do	2,142	1,747	1,760	1,641	[1] 1,466

INDEX NUMBERS (1957-59=100)

	Average 1957-59	1960	1961	1962	1963, 9 months
General economy:					
Gross national product (GNP)	100.0	110.0	113.5	121.5	127.0
Industrial production (FRB)	100.0	108.7	109.8	118.3	123.5
Employment (nonagricultural)	100.0	103.4	104.1	106.5	108.0
Consumer prices (all commodities)	100.0	101.7	102.4	103.2	104.0
Wholesale prices (all commodities)	100.0	100.7	100.3	100.6	100.2
Oil and gas production:					
Crude oil prices	100.0	96.7	96.7	96.0	96.0
Gasoline prices (service station, excise tax)	100.0	97.2	94.9	94.4	93.5
Employment	100.0	93.9	92.4	91.0	89.2
Exploratory wells drilled	100.0	92.1	87.8	86.0	80.6
Active rotary drilling rigs	100.0	81.6	82.2	76.6	68.4

[1] Annual rate.

Sources of data: Gross national product from U.S. Department of Commerce; industrial production from Federal Reserve Board; employment from U.S. Bureau of Labor Statistics; consumer prices from U.S. Bureau of Labor Statistics; wholesale prices from U.S. Bureau of Labor Statistics; crude oil prices from Independent Petroleum Association of America; gasoline prices from Platt's Oilgram Price Service; exploratory wells drilled from Oil and Gas Journal; active rotary drilling rigs from Hughes Tool Co.

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

Senator TALMADGE. May I ask a question, Mr. Chairman?

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. What in your judgment, Mr. Decker, is the cause of the decline in the number of drilling rigs, the decline in the number of wildcat wells drilled, and the decline in the number of employees in the oil and gas industry? Is it because of overproduction?

Mr. DECKER. Well, there is a surplus of crude oil throughout the world. There is a surplus of crude oil producing capacity within the United States. It is a combination of competition by the importing companies, and the general cost-price squeeze existing in the industry.

There is also a growing trend of the inherent fear of tax changes that would make the climate for the domestic producer not as good as it has been in the past. In order for the domestic producer to reinvest his money and go back in business and continue in the business, he has to feel that, one, he is going to have an adequate return on his investment, two, that he is going to have a climate, a tax climate, that is going to encourage him, and three, that he is going to have the ability to find natural crude oil and natural gas.

We find as far as the independent domestic producer, that he is finding it more difficult to find sufficient quantities of natural gas and crude oil, he is finding it more difficult to turn over his dollars fast enough from production he now has in order to continue in the business. He has also found that it may be more profitable for him in the short run to shell his domestic production at this time, and that is why we have had so many sellouts in the last few years.

Does that partially answer your question?

Senator TALMADGE. Yes. Thank you.

The CHAIRMAN. Any further questions?

Senator WILLIAMS. Mr. Decker, you state that the rate of return for petroleum companies was lower, not only for the entire period but also for each of the 8 years.

How does the cash flow of the companies in the petroleum industry compare with the cash flow of other industries?

Mr. DECKER. I do not have those figures before me, Senator.

Senator WILLIAMS. If I am not mistaken it is substantially higher, as a result of the depletion allowance.

Now, were you making your comparison here on the basis of the reported tax liability or were you taking it on the basis of the net cash flow each year for the companies?

Mr. DECKER. Well, the figures that were used in this were compiled by the Chase National Bank and they comprise 33 companies, and these 33 companies comprise about two-thirds of the U.S. crude oil output for the United States.

Now, we were unable to make a survey of all the smaller producers in the United States, and we have to necessarily take the larger companies which have published information.

Now, this information which we show here, as I said, comes from the 33 larger companies, and not from the thousands of smaller indepedent companies, which I know, if it were compiled would show an even less return.

Senator WILLIAMS. Well, I will direct my question to those 33 companies.

How did the cash flow of these 33 companies compare with the industry generally?

Mr. DECKER. I do not have that figure before me. Dr. Gonzalez, could you answer that?

Mr. GONZALEZ. No, I have no information on that.

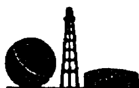
Senator WILLIAMS. Could you give us a list of the 33 companies involved together with a copy of their report?

Mr. DECKER. Well, we will see that it is filed.

(The following information was received for the record:)

FINANCIAL ANALYSIS OF 33 PETROLEUM COMPANIES 1962

By G. STANLEY PLATT
with
John D. Emerson / Norma J. Anderson / Richard C. Sparling



Petroleum Division

THE CHASE MANHATTAN BANK

SEPT. 1963

COMPANIES INCLUDED IN STUDY

Amerada Petroleum Corporation
Apco Oil Corporation
Ashland Oil & Refining Company
The Atlantic Refining Company
Champlin Oil & Refining Co.
Cities Service Company
Continental Oil Company
Getty Oil Company
Gulf Oil Corporation
Hydrocarbons Division—Monsanto Chemical Company
The Louisiana Land and Exploration Company
Marathon Oil Company
Murphy Corporation
Phillips Petroleum Company
The Pure Oil Company
Richfield Oil Corporation
Shell Oil Company
Signal Oil and Gas Company
Sinclair Oil Corporation
Skelly Oil Company
Socony Mobil Oil Company, Inc.
Standard Oil Company of California
Standard Oil Company (Indiana)
Standard Oil Company (New Jersey)
The Standard Oil Company (Ohio)
Sun Oil Company
Sunray DX Oil Company
The Superior Oil Company
Texaco Inc.
Texas Gulf Producing Company
Texas Pacific Coal and Oil Company
Tidewater Oil Company
Union Oil Company of California

This study is based on data secured from annual reports to stockholders and to the Securities and Exchange Commission and on information developed from other sources. The Petroleum Division of The Chase Manhattan Bank wishes to thank the companies and individuals who have cooperated in supplying special information and material used in this survey. Additional copies may be obtained from the Petroleum Division, The Chase Manhattan Bank, 1 Chase Manhattan Plaza, New York 15, N. Y.

FOREWORD

For many years the Petroleum Division of The Chase Manhattan Bank has conducted a detailed study of the financial performance of a large number of petroleum companies. Because the combined operations of these companies constitute a major proportion of the world-wide activities of the petroleum industry, their combined financial performance provides a valuable basis for determining the probable experience of the over-all industry.

As a service to the petroleum industry, and all others with a related interest, the Bank has published annually since 1945 the summarized results of this study.

The companies included in this study are the 33 listed on the adjoining page. Throughout this report they are referred to collectively as "The Group." Over the years the composition of The Group has changed slightly. But this does not affect to a significant degree comparisons of current data with those of prior years.

INTRODUCTION

Of all the crude oil produced throughout the Free World in 1962, The Group alone accounted for as much as 58.6 percent. Its proportion in the United States was 64.2 percent; and abroad, it was 55.3.

In refining, The Group's operations represented 59.4 percent of the worldwide total. It processed 87.3 percent of the oil refined in the United States, and accounted for 39.9 percent of the foreign throughput.

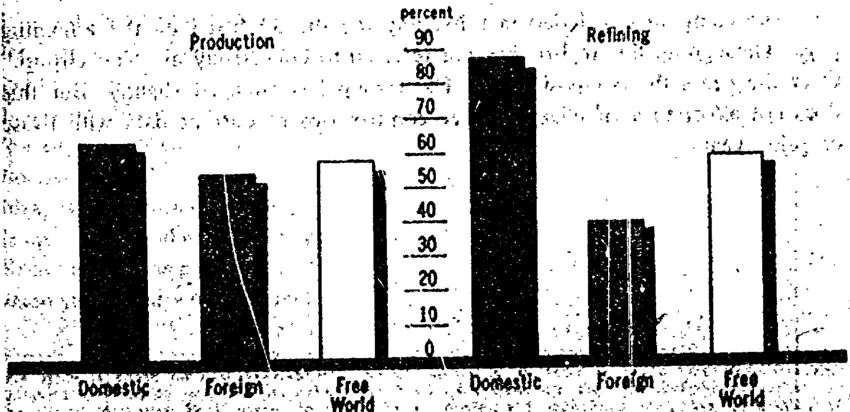
Over the past decade, The Group's share of Free World crude oil production has not changed significantly. But its proportion of refinery runs has fallen moderately.

Crude oil production in 1962 was higher than ever before—both in the United States and abroad. Foreign output accounted for 60.1 percent of the total. And four-fifths of the production increment also occurred in foreign areas.

Here are the results of The Group's operations in 1962:

	1962	1961	Change	
	Thous. Bbls. Per Day		T B/D	%
Crude Oil Prod.	11,797	10,819	+978	+9.0
Refinery Runs	12,135	11,649	+486	+4.2

Refinery runs were also at a record level in domestic and foreign areas alike. Although a major share—60.5 percent—of The Group's throughput was in the United States, foreign operations accounted for two-thirds of the 1962 refining increase.



EARNINGS

After an interval of five years, The Group once again saw its earnings reach a new record level. Net income in 1962, totaling 3.3 billion dollars, exceeded by approximately a quarter of a billion the previous high set in 1957.

Over-all, the 1962 earnings were 8 percent higher than those achieved the year before. But, as this table shows, the greater part of the gain stemmed from operations abroad:

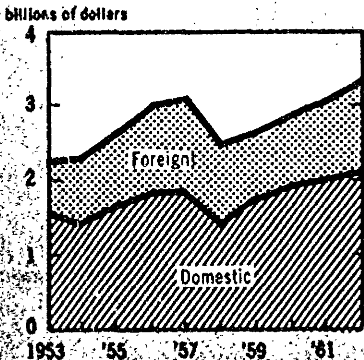
Earnings	1962	1961	Change Mill. $	Change %
	Million Dollars			
Domestic	2,098	2,018	+ 80	+ 4.0
Foreign	1,246	1,078	+168	+15.6
Total	3,344	3,096	+248	+ 8.0

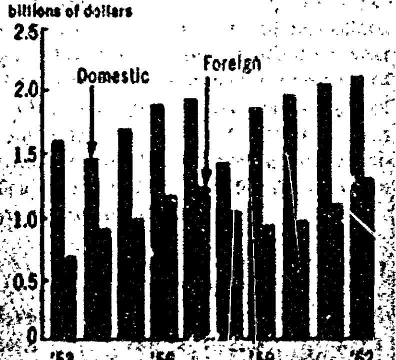
Of the total earnings increment, two-thirds flowed from The Group's foreign activities. In part, this development reflects the larger volumetric gain in petroleum consumption abroad. It shows also the braking effect on domestic earnings of the severe gasoline price warfare that prevailed during the first half of the year.

The proportion of net income generated from foreign operations rose from 34.8 percent the year before to 37.3 in 1962. Despite this gain, the foreign share was not the largest on record. It has been higher on three occasions in the past, and reached a peak of 41.7 percent in 1958, when domestic earnings were limited by a general business recession.

Not all of the companies comprising The Group shared in the 1962 expansion of earnings—9 of the 33 experienced a decline. Here are the salient features:

Earnings	1962	1961	Change Mill. $	Change %
	Million Dollars			
24 Companies	3,062	2,792	+270	+9.7
9 Companies	282	304	− 22	−7.2
33 Companies	3,344	3,096	+248	+8.0

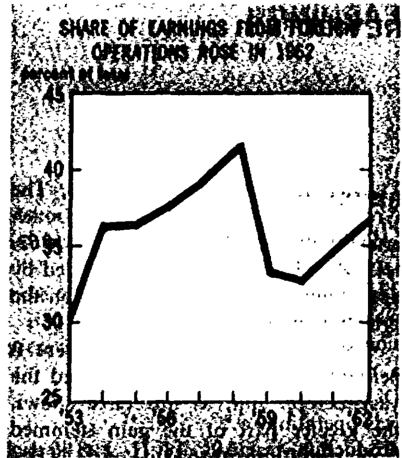




Virtually all of the decline registered by the 9 companies can be traced to their domestic operations.

Among the companies included in The Group are some that have operated internationally for a long time and others that have become international in character only in recent years. The latter, as a unit, achieved in 1962 for the first time a significant volume of earnings from foreign operations. Of The Group's earnings increment abroad in 1962, the newer internationals contributed one-third. But, while these companies were progressing in foreign areas, they were losing ground on the domestic scene where the long established internationals increased their share of The Group's earnings. These crosscurrents are, of course, manifestations of the highly competitive nature of the petroleum business.

For the most part, The Group's gain in earnings in 1962 was concentrated in the second half of the year. Of the annual increment, three-fourths occurred during the last six months. Partly re-

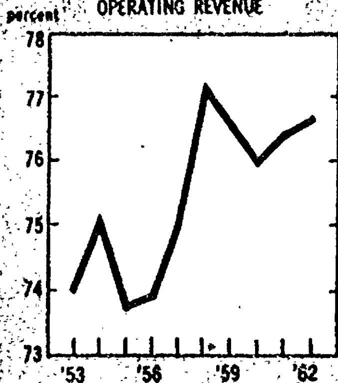


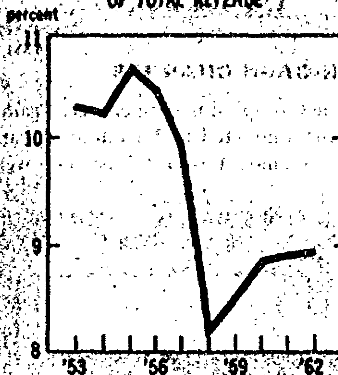
sponsible for this development was the changing pattern of domestic earnings —from a decline in the first half to a strong gain in the second as a result of price weakening followed by recovery. Also, severe weather in the latter half of the year, both in the United States and abroad, stimulated petroleum consumption.

REVENUE AND COSTS

REVENUE

With an increase of 7.5 percent, The Group's gross revenue in 1962 totaled 37.5 billion dollars. This rate of gain was somewhat smaller than the expansion of petroleum produced and sold—a manifestation of price deterioration. Of the total dollar volume, 97.6 percent was operating revenue derived from the production, transportation, refining, and marketing of petroleum hydrocarbons—oil and natural gas. Oil was by far the more important source of income. Although natural gas constituted almost one-third of the petroleum energy produced and sold in 1962, it supplied less than 4 percent of The Group's revenue. And out of every additional dollar of revenue in 1962, natural gas contributed only 2 cents.





OPERATING COSTS

All the major elements of The Group's cost of doing business rose in 1962. Taken together, their rise was in proportion to the gain in gross revenue. But, individually, some increased more and others less.

Operating costs, excluding taxes, advanced to a level of 28 billion dollars. And for the second consecutive year they represented a higher proportion of revenue—despite the vigorous efforts of individual companies to reduce costs wherever possible. Of even greater significance are the changes for the past five years shown in this table:

	1962	1957	Change
	Billion Dollars		%
Revenue	36.6	30.6	+19.6
Costs	28.0	22.9	+22.2
Net Income	3.3	3.1	+ 7.9

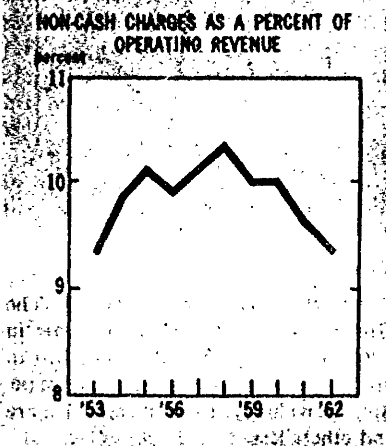
The failure of revenue to expand by a rate at least equal to the growth of costs is a result of price erosion over the past five years. Had revenue kept pace with costs, the percentage gain for net income would have been very much larger—about treble that shown in the table.

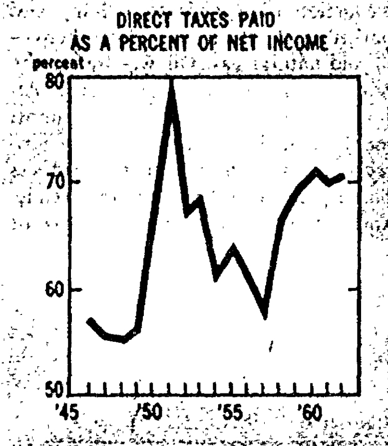
NON-CASH CHARGES

The Group's non-cash charges against income amounted to 3.5 billion dollars. Of this amount over 97 percent went to provide for depreciation, depletion, and retirement of physical plant and equipment. Although these charges were 5.9 percent greater than the year before, they represented a lesser proportion of revenue—continuing a trend in evidence the past four years.

TAXES

In the form of direct taxes, The Group paid to domestic and foreign governments in 1962 a total of 2.3 billion dollars—9 percent more than in the previous year. The increase of 193 mil-



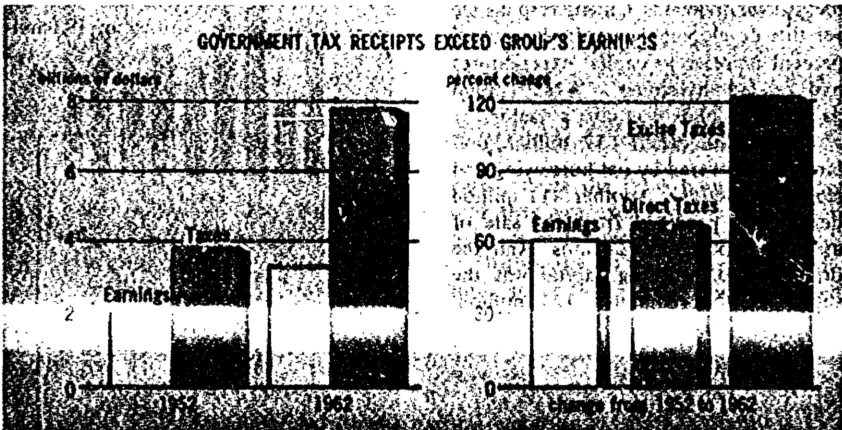


lion dollars was equal to more than three-fourths of the gain in net earnings.

In its onerous role of tax collector for government, The Group extracted from its customers 5.5 billion dollars in sales and excise taxes. The collection was 374 million—7.3 percent—more than in 1961.

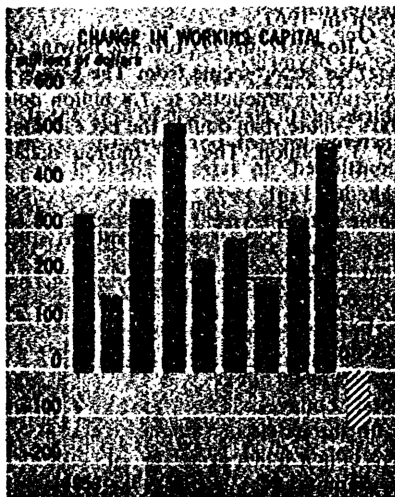
Altogether, the tax revenue flowing to various governments from The Group's operations amounted to 7.8 billion dollars—more than double the net earnings of 3.3 billion. The 567 million dollar tax increment was also more than double the 248 million dollar gain in earnings. Clearly, The Group benefits far less from its operations than does government. And, as this table shows, the share going to government has increased over the past decade.

	1962	1952	Change	
	Million Dollars		Mill. $	%
Government Tax Revenue	7,844	3,868	+3,976	+102.8
The Group's Earnings	3,344	2,075	+1,269	+ 61.2

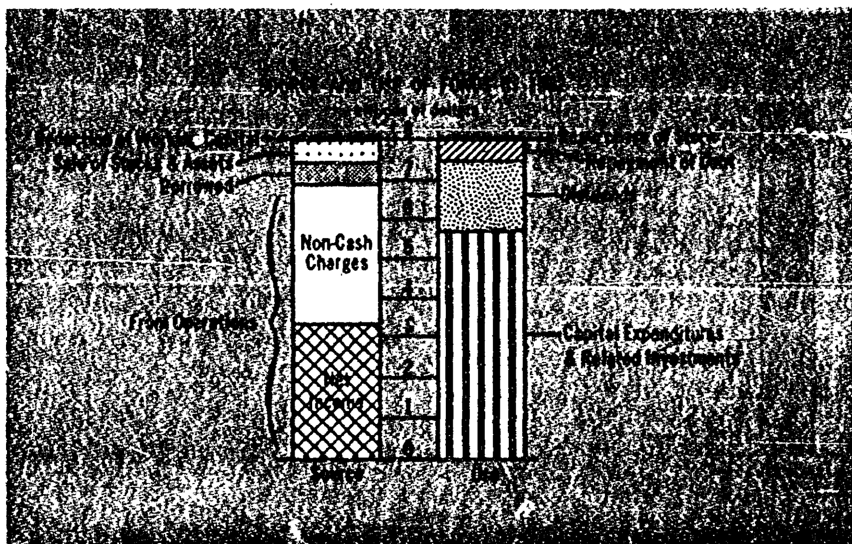


SOURCE AND USE OF FUNDS

For the first time since 1946, The Group experienced a decline in its working capital. Even though cash income rose by 7.5 percent to a record level of 6.9 billion dollars, it still fell short by 569 million of meeting cash requirements for capital expenditures, investments, and dividends. Chiefly responsible for this development was the large 16.6 percent increase in capital expenditures and related investments. A substantial gain in dividends was also a factor.



Part of the deficit—37 million dollars—was covered by net borrowing and stock transactions. Another 411 million dollars was provided from the sale of assets and other transactions. And the drawdown of working capital was the source of the remaining 121 million.

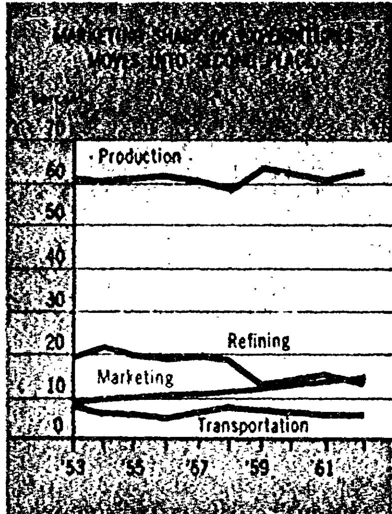


CAPITAL EXPENDITURES

Only once before—in 1957—did The Group spend so much for capital account. The outlay in 1962 was 5.2 billion dollars, 14 percent more than in 1961—and, incidentally, 55 percent more than net earnings.

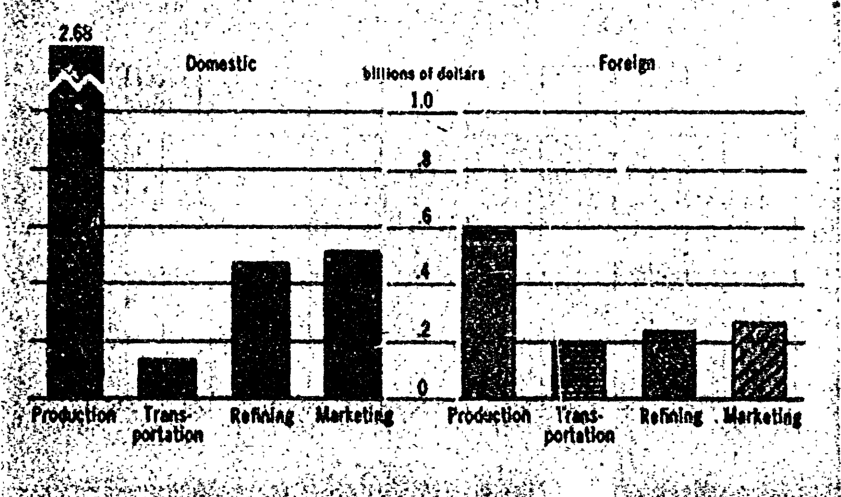
One factor alone—offshore lease bonus payments in the United States—was responsible for more than two-thirds of the total capital expenditure increment. Whether the bonus payments constituted an outlay in addition to scheduled programs or a diversion from some other purpose is a debatable question. But it seems plausible to presume that both reasons may have been involved.

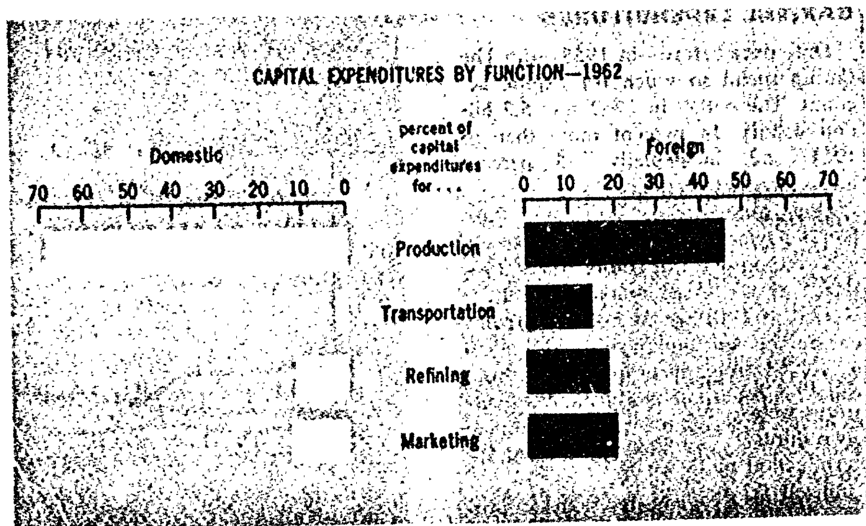
Expenditures connected with the production of crude oil and natural gas represented almost two-thirds of the total outlay—a proportion consistent with the pattern of the past. A total of 3.3 billion dollars was spent—17.5 percent more than in 1961. Most of the



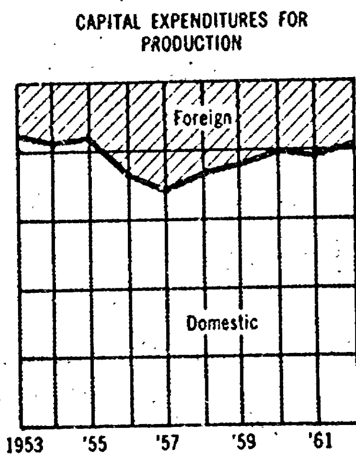
gain reflects the lease bonus payments—if they are excluded the production increase is limited to only 1.8 percent.

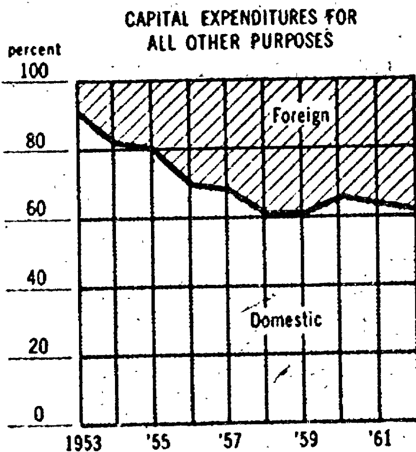
Historically, The Group's expenditures for refining have always ranked





second after production. But in 1962 the pattern changed, and the outlay for marketing facilities for the first time exceeded the refining expenditure. The 788 million dollars spent for marketing was 16 percent more than in 1961. Of The Group's integrated activities, refining was the only one for which there was no increase in capital expenditures —the 711 million dollars spent for this activity was slightly less than in 1961. For transportation purposes there was an outlay of 336 million dollars, an increase of 14.3 percent.



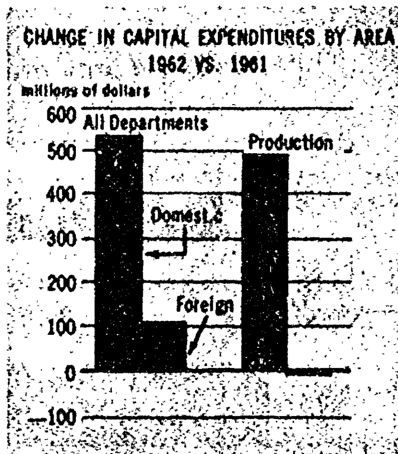


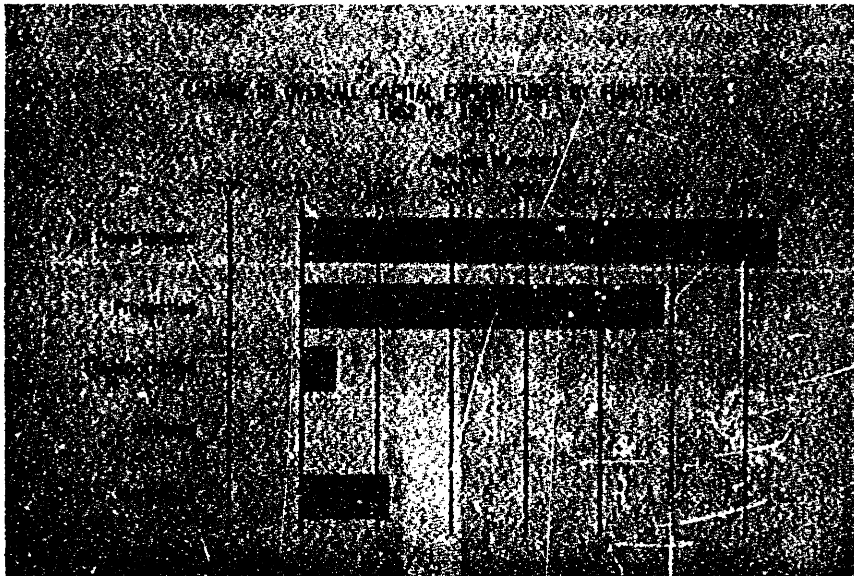
As this table shows, a major portion—as much as three-fourths—of the over-all capital outlay was made in behalf of domestic operations. And the expenditure increment was also much larger in the United States.

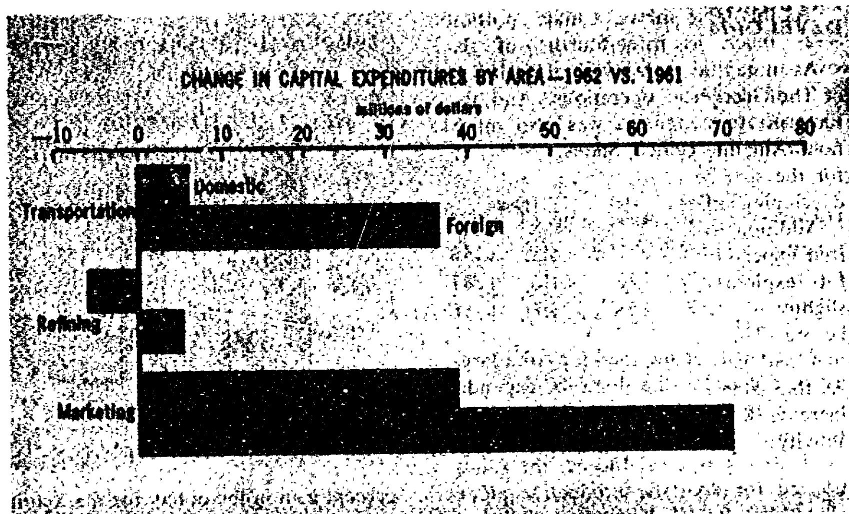
Expenditures	1962	1961	Change	
	Million Dollars		Mill. $	%
Domestic	3,888	3,355	+533	+15.9
Foreign	1,310	1,205	+105	+ 8.7
Total	5,198	4,560	+638	+14.0

As a result of the increase—the largest in a decade—the domestic expenditures were the highest ever. More than two-thirds of the money was spent for production purposes. Indeed, the funds utilized for domestic production alone exceed the sum of all other expenditures by The Group—both domestic and foreign. Also, almost all—92 percent—of the domestic expenditure increment in 1962 was devoted to production.

The only other increase of significance on the domestic scene was a 7.9 percent gain in the outlay for marketing—to 521 million dollars. Primarily to upgrade its facilities rather than add to capacity, The Group spent 467 million dollars for refining—1.3 percent less than in 1961. For transportation, it spent 139 million dollars—6 million more than the year before. There was

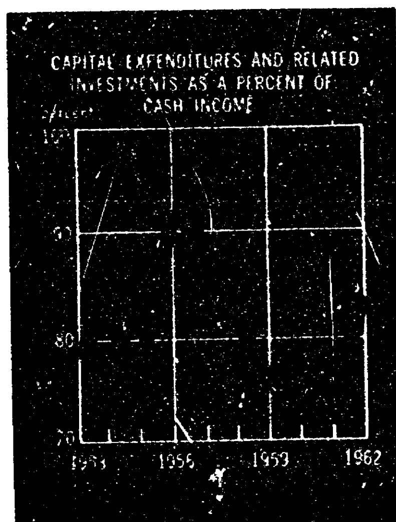


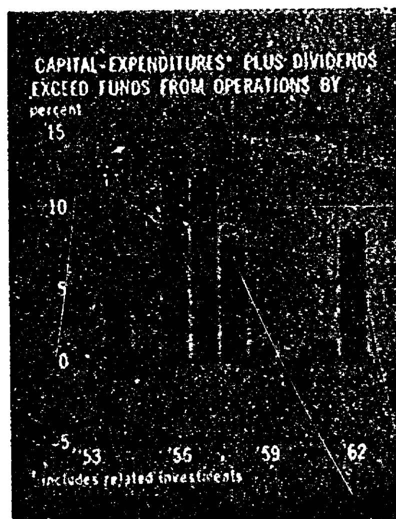




a substantial increase in the outlay for pipelines, offset largely by a reduced expenditure for marine purposes.

The Group's foreign expenditures represented a quarter of its total outlay—a slightly smaller percentage than in 1961. In contrast with the domestic pattern, a substantially smaller proportion of the money spent was for production. And there was also a reduction in the amount used for this purpose—from 597 to 592 million dollars. Of the overall increase in foreign expenditures, marketing accounted for about two-thirds and transportation one-third. For refining there was only a slight increase.





EXPLORATION AND DEVELOPMENT COSTS

As noted earlier, almost two-thirds of The Group's over-all capital expenditures in 1962 was allocated to production. And the bulk of this outlay was for the specific purpose of finding and developing oil and gas reserves.

Additionally, there was a non-capitalized expenditure of 640 million dollars for exploration and lease rentals—slightly more than was spent the year before. This increase halted a decline that had been in progress since 1957. As this table reveals, most of the 1962 increase was connected with domestic activity:

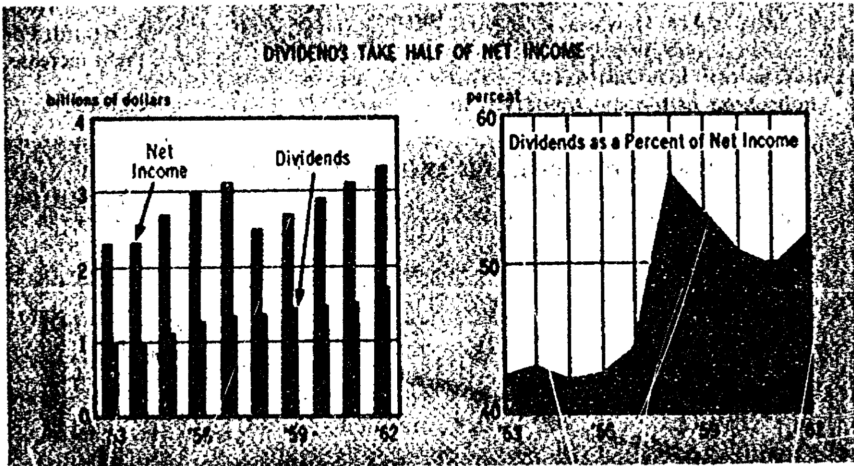
	1962	1961	Change	
	Million Dollars		Mill. $	%
Domestic	464	445	+19	+4.3
Foreign	176	174	+ 2	+1.1
Total	640	619	+21	+3.4

Altogether, The Group spent in 1962 to maintain and expand its production of oil and gas a total of 3.8 billion dollars—14.9 percent more than in 1961.

DIVIDENDS

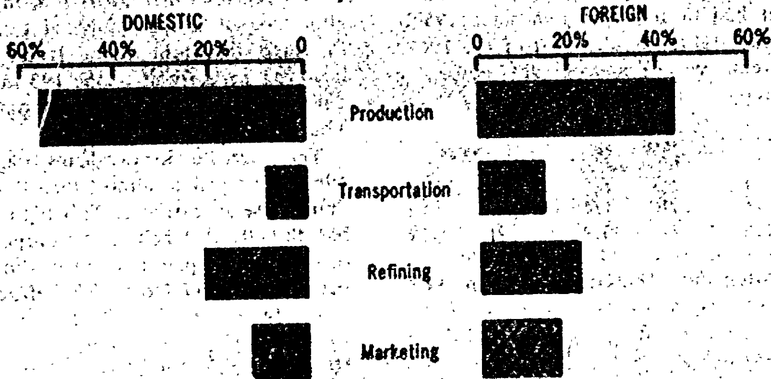
To its stockholders The Group paid 1.7 billion dollars in cash dividends—11.5 percent more than in 1961. Divident payments have risen in all of the postwar years, but the 177 million dollar increase in 1962 was the largest by a substantial margin. It was, in fact, almost equal to the combined gain for the preceding four years. It did not, however, measure up to the 193 million dollar increase in direct taxes paid by The Group.

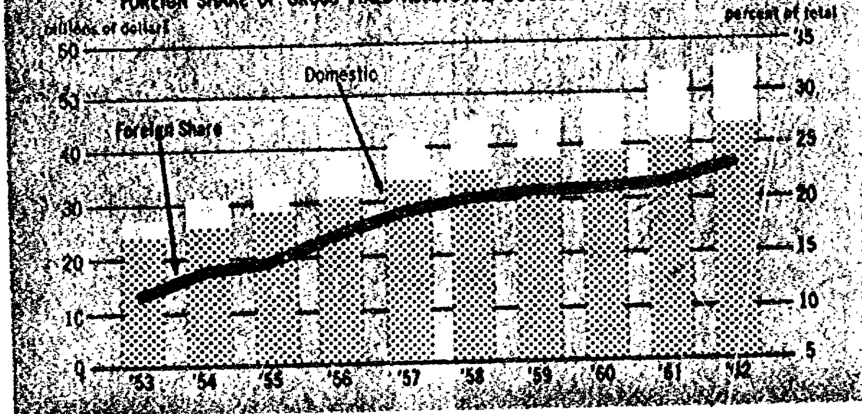
The increase in dividends paid in 1962 was equal to almost three-fourths of the rise in earnings. This high ratio had the effect of raising the proportion of net earnings paid in dividends to 51.3 percent from 49.8 the year before.



PROPERTY, PLANT, AND EQUIPMENT

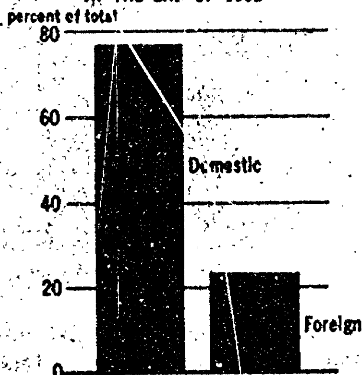
Year after year, throughout the postwar period, The Group's gross investment in fixed assets has mounted steadily. During that time it has more than quadrupled—an average gain of almost 10 percent a year. In 1962 there was a continued growth of 7.4 percent, as the asset value rose from 53.3 to

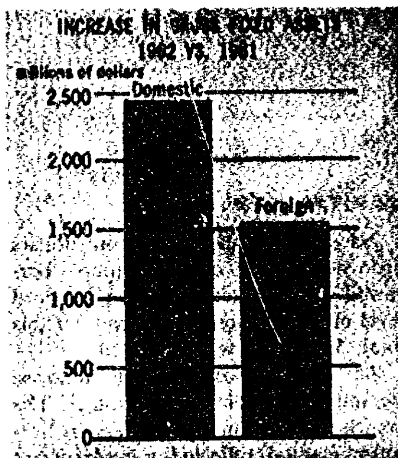




57.2 billion dollars.

The greater part of this investment—over three-fourths—was in the United States. And a major portion of the 1962 increment occurred there also. Of the 2.4 billion dollar rise in domestic investment, as much as 62 percent was for production purposes. Indeed, the domestic addition to production investment alone was about equal to the combined investment gain for all purposes outside the United States.





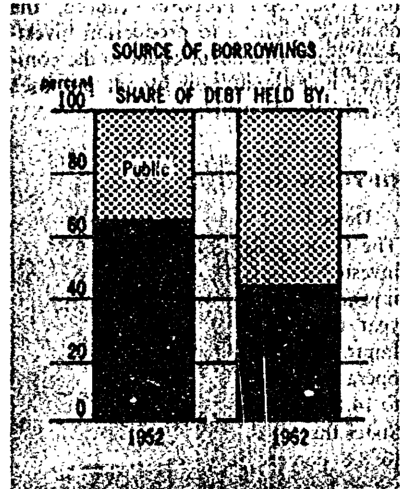
The Group increased its investment abroad by 1.5 billion dollars in 1962. With this increase, the foreign investment represented 23 percent of the total compared with 21.9 the year before. Ten years ago, the foreign share was only 11.8 percent. In contrast with the domestic pattern, less than half of the foreign investment is for production purposes. And more than three-fourths of the 1962 increment was in behalf of operations other than production."

RATE OF RETURN

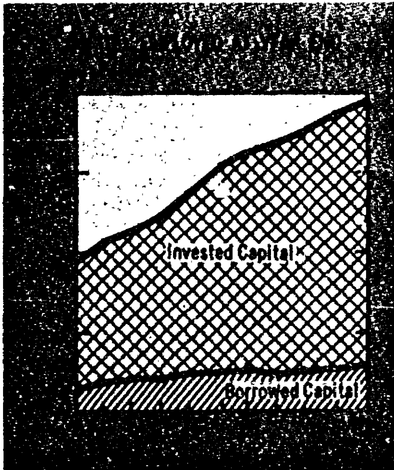
CAPITAL EMPLOYED

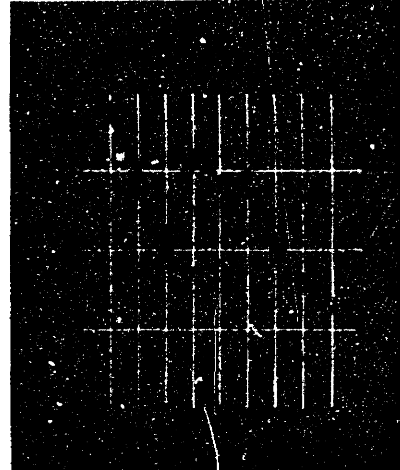
An increase of 1.9 billion dollars brought the sum of The Group's borrowed and invested capital to a record level of 39.1 billion at year end. Of this total, 5.1 billion was borrowed.

As usual, most of the increase stemmed from reinvested earnings. The net rise of 134 million dollars in borrowed capital reflected a replacement of private debt with public debt—a shift that has occurred frequently in recent years. A decade ago private placement of loans constituted 65 percent of borrowed capital. But, by 1962, public offerings had moved into the forefront and accounted for 57 percent of the total.



At the end of 1962 The Group's ratio of debt to total capital employed was 13 percent—the lowest since 1946. The 5.1 billion dollars of stated debt does not, however, include capital made available for The Group's benefit through the means of long-term lease

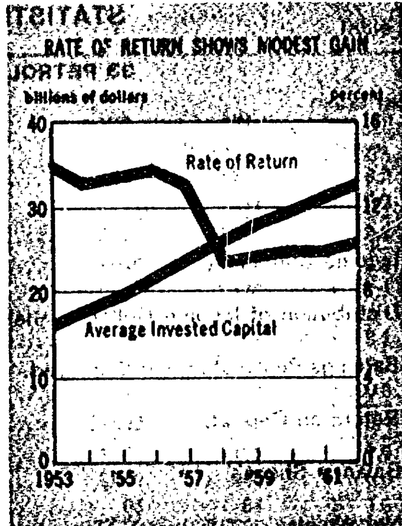




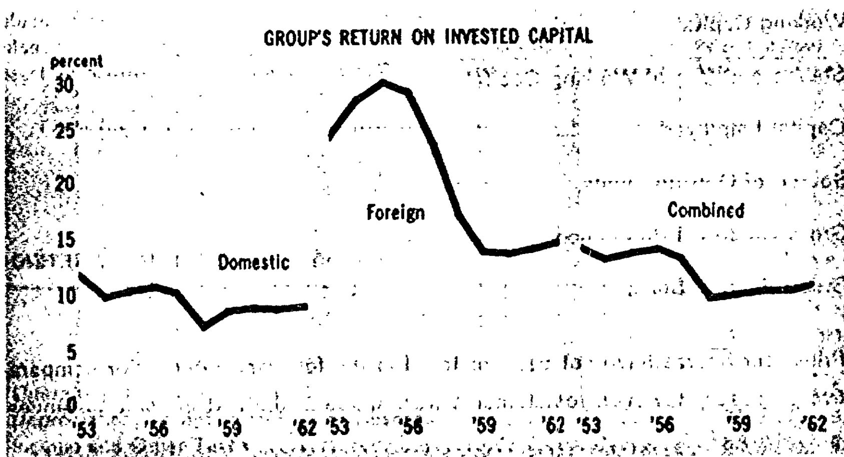
rentals and producton payment loans. From incomplete data currently at hand it is estimated that The Group's debt would be almost double the stated amount if these additional sources of financing were included. On that basis, the ratio of debt to capital employed would be close to 25 percent. The Group is also contingently liable for guaranteed loans and other obligations amounting to approximately 525 million dollars.

RETURN ON INVESTED CAPITAL

Despite the sizeable gain in earnings, The Group's rate of return on average invested capital did no more than inch upward to 10.3 percent from 10.0 the year before. The bulk of the over-all improvement can be traced to foreign operations where the return advanced to 14.6 percent from 13.9. In the United States there was only a fractional change to 8.8 percent from 8.7.



Over the past decade The Group's average invested capital has more than doubled. But its rate of return over the same span of years has fallen by a fourth.



STATISTICAL TABLES

33 PETROLEUM COMPANIES

Income Statement.

Distribution of Income Dollar.

Earnings Reinvested and Employed.

Return on Capital.

Balance Sheet.

Net Assets.

Expenditures for Fixed Assets.

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Investment in Fixed Assets.

Working Capital.

Source and Use of Working Capital.

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Source of Outside Funds.

Gross Crude Oil Production.

Crude Runs to Stills.

Prior year figures have not been restated in the following tables. For comparative purposes, however, restatements were made in the text in some instances.

INCOME STATEMENT — Table 1

	1962	1961	Change 1962 from 1961
	Million Dollars		Percent
Gross Operating Income	36,561	33,784	+ 8.2
Non-Operating Income	912	792	+ 15.2
Total Income	37,473	34,576	+ 8.4
Operating Costs and Expenses	28,015	25,804	+ 8.6
Taxes—Other than Income Taxes (a)	1,307	1,176	+ 11.1
Depreciation, Depletion, Amortization and Retirements	3,429	3,237	+ 5.9
Interest Expense	257	227	+ 13.2
Other Charges	14	7	+100.0
Total Deductions	33,022	30,451	+ 8.4
Net Income before Income Taxes	4,451	4,125	+ 7.9
Estimated Income Taxes	1,042	980	+ 6.3
Income Applicable to Minority Interest	65	64	+ 1.6
NET INCOME (b) (c)	3,344	3,081	+ 8.5

(a) Excludes $5,495 million in 1962 and $5,121 million in 1961 representing sales and excise taxes on gasoline and other refined products, which are collected from customers and accounted for to United States federal, state and city authorities, and to foreign governments. Such taxes are deducted before arriving at gross operating revenue.

(b) Includes earnings from foreign operations: 1962—$1,246 million and 1961—$1,078 million.

(c) Net income by quarters:

	1962	1961	1962	1961
	Million Dollars		Percent of Total	
First Quarter	833	806	24.9	26.2
Second Quarter	737	704	22.1	22.8
Third Quarter	813	730	24.3	23.7
Fourth Quarter	961	841	28.7	27.3
Total	3,344	3,081	100.0	100.0

DISTRIBUTION OF INCOME DOLLAR — Table 2

	1962	1961
	Cents	
Operating Costs and Expenses	75.4	75.3
Depreciation, Depletion and Other Charges	9.2	9.4
Income and Other Taxes	6.3	6.2
Income Applicable to Minority Interests	0.2	0.2
Dividends to Stockholders	4.6	4.4
Reinvested in Business	4.3	4.5
TOTAL INCOME	100.0	100.0

EARNINGS REINVESTED AND EMPLOYED Table 3

	Million Dollars
Balance at December 31, 1961	18,408
Add: Net Income	3,344
	21,752
Less: Cash Dividends	1,716
Stock Dividends	409
Other Charges	—370
Balance at December 31, 1962	19,997

RETURN ON CAPITAL Table 4

	1962	1961
	Million Dollars	
Average Borrowed and Invested Capital (a)	38,197	36,417
Earnings (b)	3,667	3,372
Return	9.6%	9.3%
Average Invested Capital (c)	32,517	30,897
Earnings (d)	3,344	3,081
Return	10.3%	10.0%

(a) Includes long-term debt, preferred stock, common stock, surplus and equity of minority interests.

(b) Represents net income plus interest charges and income applicable to minority interests.

(c) Includes preferred stock, common stock and surplus.

(d) Represents net income.

Note: The return on average total assets of $45,817 million amounting to $3,409 million (before deducting income applicable to minority interests) was 7.4% in 1962.

BALANCE SHEET Table 5

ASSETS	12/31/62	12/31/61	Distribution 1962	Distribution 1961
	Million Dollars		Percent	
Currents Assets	14,323	13,744	30.4	31.0
Investments and Advances	2,242	2,137	4.8	4.8
Long-Term Receivables	685	596	1.4	1.3
Special Funds and Deposits	54	70	0.1	0.2
Property, Plant and Equipment (a)	29,275	27,339	62.1	61.7
Prepaid Charges and Other Assets	559	444	1.2	1.0
TOTAL ASSETS	47,138	44,330	100.0	100.0
LIABILITIES AND NET WORTH				
Current Liabilities	6,536	5,836	13.9	13.2
Long-Term Debt	5,070	4,936	10.8	11.1
Deferred Credits	675	580	1.4	1.3
Other Reserves	827	736	1.7	1.7
Minority Interests	669	625	1.4	1.4
Net Worth:				
Preferred Stock	183	241	0.4	0.5
Common Stock and Capital Surplus	13.181	12,968	28.0	29.3
Earnings Reinvested in Business	19,997	18,408	42.4	41.5
Shareholders' Equity	33,361	31,617	70.8	71.3
TOTAL LIABILITIES AND NET WORTH	47,138	44,330	100.0	100.0

(a) After deducting accumulated reserves of $27,960 million in 1962 and $25,924 million in 1961.

NET ASSETS
DECEMBER 31, 1962 Table 6

	United States	Other Countries	Combined
	Million Dollars		
Working Capital	6,293	1,494	7,787
Investments and Advances	699	1,543	2,242
Property, Plant and Equipment (a)	21,668	7,607	29,275
Other Assets	1,091	207	1,298
	29,751	10,851	40,602
Less: Long-Term Debt	4,437	633	5,070
Other Reserves and Credits	872	630	1,502
Minority Interests	70	599	669
Preferred Stock	183	0	183
TOTAL NET ASSETS	24,189	8,989(b)	33,178
Percent Distribution	72.9	27.1	100.0

(a) After deducting accumulated reserves of $22,379 million for domestic facilities and $5,571 million for foreign facilities.

(b) Distribution by areas:

	Million Dollars	Percent of Total
Western Hemisphere	4,976	55.4
Eastern Hemisphere	4,013	44.6
Total	8,989	100.0

EXPENDITURES FOR FIXED ASSETS
YEAR 1962 Table 7

	United States	Other Countries	Combined
		Million Dollars	
Production:			
Crude Oil and Natural Gas (a)	2,559	587	3,146
Gasoline and Cycling Plants	123	5	128
Total	2,682	592	3,274
Transportation:			
Pipe Lines	90	34	124
Marine	33	157	190
Other	16	6	22
Total	139	197	336
Refineries and Chemical Plants	467	244	711
Marketing	521	267	788
Others	79	10	89
TOTAL	3,888	1,310	5,198

(a) Excludes exploration expenses and lease rentals charged to income account.

Area	1962	1961	1960	1959	1958
			Million Dollars		
United States	3,888	3,356	3,170	3,037	2,972
Canada	259	282	263	288	294
Venezuela	144	135	178	316	404
Other Countries	214	183	202	214	196
WESTERN HEMISPHERE	4,505	3,956	3,813	3,855	3,866
Western Europe	356	373	290	309	346
Africa	203	168	107	44	63
Middle East	29	56	29	51	80
Far East	105	7	2	7	1
EASTERN HEMISPHERE	693	604	428	411	490
TOTAL WORLD-WIDE	5,198	4,560	4,241	4,266	4,356

CAPITAL AND EXPLORATION EXPENDITURES
YEAR 1962 TABLE 8

	United States	Other Countries	Combined
		Million Dollars	
Production Expenditures	2,188	442	2,630
Dry Holes	371	145	516
Total	2,559	587	3,146
Geological & Geophysical Expenses & Lease Rentals	464	176	640
EXPLORATION AND DEVELOPMENT COSTS	3,023	763	3,786
Other Capital Expenditures	1,329	723	2,052
CAPITAL AND EXPLORATION EXPENDITURES	4,352	1,486	5,838

INVESTMENT IN FIXED ASSETS
DECEMBER 31, 1962

Table 9

	Gross			Net		
	United States	Other Countries	Combined	United States	Other Countries	Combined
	Million Dollars					
Production:						
Crude Oil and Natural Gas	23,407	5,800	29,207	11,268	3,097	14,365
Gasoline and Cycling Plants	1,406	92	1,498	674	71	745
Total	24,813	5,892	30,705	11,942	3,168	15,110
Transportation:						
Pipe Lines	2,593	516	3,109	1,241	277	1,518
Marine	654	1,338	1,992	315	947	1,262
Other	191	12	203	84	8	92
Total	3,438	1,866	5,304	1,640	1,232	2,872
Refineries and Chemical Plants	9,511	2,963	12,474	4,260	1,688	5,948
Marketing	5,344	2,315	7,659	3,255	1,426	4,681
Others	941	142	1,083	571	93	664
TOTAL	44,047	13,178	57,225	21,668	7,607	29,275

	1962		1961	
	Gross	Net	Gross	Net
	Million Dollars			
United States	44,047	21,668	41,605	20,468
Canada	3,016	1,866	2,745	1,745
Venezuela	3,827	1,645	3,798	1,853
Other Countries	1,850	1,190	1,715	1,045
WESTERN HEMISPHERE	52,740	26,369	49,863	25,111
Western Europe	2,797	1,768	2,486	1,590
Africa	767	542	532	403
Middle East	385	235	371	227
Far East	536	361	11	8
EASTERN HEMISPHERE	4,485	2,906	3,400	2,228
TOTAL WORLD-WIDE	57,225	29,275	53,263	27,339

WORKING CAPITAL — Table 10

	12/31/62	12/31/61	Change 1962 from 1961	Distribution 1962	Distribution 1961
	Million Dollars			Percent	
Cash	1,860	1,673	+187	13.0	12.2
Marketable Securities	2,689	3,092	−403	18.8	22.5
Accounts and Notes Receivable (net)	5,538	4,944	+594	38.7	36.0
Inventories:					
Crude Oil, Refined Products and Other Merchandise	3,615	3,346	+269	25.2	24.3
Materials and Supplies	607	638	− 31	4.2	4.6
All Other	14	51	− 37	0.1	0.4
TOTAL CURRENT ASSETS	14,323	13,744	+579	100.0	100.0
Accounts Payable	3,314	3,008	+306	50.7	51.6
Notes and Loans Payable	877	631	+246	13.4	10.8
Income and Other Taxes	1,523	1,496	+ 27	23.3	25.6
All Other	822	701	+121	12.6	12.0
TOTAL CURRENT LIABILITIES	6,536	5,836	+700	100.0	100.0
WORKING CAPITAL	7,787	7,908	−121	—	—
Ratio of C.A. to C.L.	2.2	2.4	—	—	—

SOURCE AND USE OF WORKING CAPITAL
YEAR 1962 — Table 11

	Million Dollars	Percent Distribution
Funds Available From:		
Cash Earnings (a)	6,869	86.3
Long-Term Debt Issued	504	6.3
Preferred and Common Stock Issued	173	2.2
Sales of Assets and Other Transactions	411	5.2
TOTAL	7,957	100.0
Funds Used For:		
Capital Expenditures	5,198	65.3
Investments and Advances	479	6.0
Dividends to Companies' Shareholders	1,716	21.6
Dividends to Minority Interests	45	0.6
Long-Term Debt Repaid	516	6.5
Preferred and Common Stock Retired	124	1.5
TOTAL	8,078	101.5
CHANGE IN WORKING CAPITAL	−121	−1.5

(a) Represents:	Million Dollars
Net Income	3,344
Write-offs	3,429
Other Non-Cash Charges (net)	96
Cash Earnings	6,869

CAPITAL EMPLOYED

Table 12

	12/31/62	12/31/61	Change 1962 from 1961	Distribution 1962	Distribution 1961
	Million Dollars			Percent	
Borrowings:					
Public	2,878	2,731	+ 147	7.4	7.4
Banks	629	712	− 83	1.6	1.9
Insurance Companies	1,233	1,225	+ 8	3.2	3.3
Others	330	268	+ 62	0.8	0.7
Total (a)	5,070	4,936	+ 134	13.0	13.3
Preferred Stock	183	241	− 58	0.5	0.6
Common Stock	8,463	8,370	+ 93	21.6	22.5
Surplus (b)	24,715	23,006	+1,709	63.2	61.9
Minority Interests	669	625	+ 44	1.7	1.7
TOTAL CAPITAL EMPLOYED	39,100	37,178	+1,922	100.0	100.0

(a) Excludes current debt due within one year, amounting to $281 million at December 31, 1962 and $240 million at December 31, 1961.

(b) Includes earnings reinvested and employed in business and capital surplus.

SOURCE OF OUTSIDE FUNDS YEAR 1962

Table 13

	Borrowings	Preferred Stock	Common Stock	Combined	Combined to Total
	Million Dollars				Percent
Public	232	70	103	405	59.8
Banks	175	0	0	175	25.9
Insurance Companies	19	0	0	19	2.8
Others	78	0	0	78	11.5
TOTAL	504	70	103	677	100.0

GROSS CRUDE OIL PRODUCTION Table 14

Area	1962	1961	Change 1962 from 1961
	Thousand Barrels Per Day		Percent
United States	4,706	4,510	+ 4.3
Canada	458	408	+ 12.3
Venezuela	2,261	2,054	+ 10.1
Other Western Hemisphere	223	214	+ 4.2
WESTERN HEMISPHERE	7,648	7,186	+ 6.4
Western Europe	104	101	+ 3.0
Africa	191	23	+730.4
Middle East	3,553	3,213	+ 10.6
Far East	301	296	+ 1.7
EASTERN HEMISPHERE	4,149	3,633	+ 14.2
TOTAL WORLD-WIDE (a)	11,797	10,819	+ 9.0

Note: The above figures include 100% of operations of companies and consolidated subsidiaries and equity in foreign operations of non-consolidated affiliates based on percentage of stock ownership.

(a) Figures expressed in million barrels are as follows:

	1962	1961
United States	1,718	1,646
Foreign Countries	2,588	2,303
Total	4,306	3,949

CRUDE RUNS TO STILLS Table 15

Area	1962	1961	Change 1962 from 1961
	Thousand Barrels Per Day		Percent
United States	7,340	7,168	+ 2.4
Canada	608	621	− 2.1
Venezuela	678	606	+11.9
Other Western Hemisphere	865	824	+ 5.0
WESTERN HEMISPHERE	9,491	9,219	+ 3.0
Western Europe	1,308	1,200	+ 9.0
Africa	37	35	+ 5.7
Middle East	837	736	+13.7
Far East	462	459	+ 0.7
EASTERN HEMISPHERE	2,644	2,430	+ 8.8
TOTAL WORLD-WIDE (a)	12,135	11,649	+ 4.2

Note: The above figures include 100% of operations of companies and consolidated subsidiaries and equity in foreign operations of non-consolidated affiliates based on percentage of stock ownership.

(a) Figures expressed in million barrels are as follows:

	1962	1961
United States	2,679	2,616
Foreign Countries	1,750	1,636
Total	4,429	4,252

.tor WILLIAMS. One further question: the percentage depletion percent was started, I believe, in 1926, was it not?
DECKER. Yes, sir.
.tor WILLIAMS. At that time what was the corporate rate?
DECKER. The corporate——
.tor WILLIAMS. Tax rate?
DECKER. I do not know offhand.
.tor WILLIAMS. It was around 12½ percent, if I recall correctly. ould admit, would you not, that as the corporate rate advanced ercent this 27½ percent depletion allowance became more and f advantage than it would be of a lower rate?
DECKER. I would say so, yes.
.tor WILLIAMS. Thank you.
CHAIRMAN. Any further questions?
eed, Mr. Gonzalez.

MENT OF RICHARD J. GONZALEZ, DIRECTOR, HUMBLE OIL & INING CO., APPEARING ON BEHALF OF AMERICAN PETRO- M INSTITUTE, MID-CONTINENT OIL & GAS ASSOCIATION, KY MOUNTAIN OIL & GAS ASSOCIATION, AND THE WESTERN & GAS ASSOCIATION

GONZALEZ. Mr. Chairman, I am Richard Gonzalez, a director nble Oil & Refining Co. My appearance today is at the request American Petroleum Institute, the Mid-Continent Oil & Gas ation, the Rocky Mountain Oil & Gas Association, and the :n Oil & Gas Association. I appreciate this opportunity to ex- vhy these organizations believe that the tax treatment that has ı effect for petroleum production over a long period of years be continued without change.
.use of the need for brevity in these hearings, if there is no on I will file a prepared statement and limit my remarks to pics: (1) the question of differential tax treatment; (2) wheth- long-established percentage depletion rate for petroleum is still oriate; (3) the proposed elimination of aggregation of petroleum ties within an operating unit; and (4) how tax receipts gen- by petroleum operations compare with those of other industries. t, as to differential tax treatment. It is not correct to assume fferential tax provisions are necessarily preferential in nature desirable. Congress has adopted many different provisions, in- ɣ the investment credit approved last year, because they serve ıl public purpose.
ɔrable rates for small business, and complete tax exemption for .ble and educational organizations, and other measures, includ- ovisions relating to development costs and production of min- ndicate a desire to encourage certain activities. On the other heavy taxes on alcohol, tobacco, and luxuries are not intended ıeutral. The appropriate issue about the tax treatment of pe- n is not whether it is neutral, but whether there are good ɜ for differential treatment, and whether the rates established ıe to serve the public interest effectively at present.

Percentage depletion was adopted not only because oil and gas are essential to national security and economic progress, but also because of the following characteristics which distinguish petroleum exploration and production from manufacturing and other nonmining ventures:

(1) Unique risks as indicated by the high proportion of unsuccessful ventures, and the large sums lost on them;

(2) Unpredictable results which keep the market value of a property from having a stable relation to its costs;

(3) The fact that mineral production depletes capital values which are not measured accurately by costs;

(4) The tendency of diminishing returns in mineral operations to raise replacement costs; and

(5) The unusually long time interval between initial outlays on new ventures and determination of their success or failure.

The conditions which led Congress to provide differential tax treatment for petroleum still exist. In fact, risks and diminishing returns are even more apparent now. In recent years, 38 percent of all wells drilled in the United States have turned out to be dry holes, compared with 27 percent back in 1926.

It is significant that an extensive review of the taxation of petroleum led the President's Materials Policy Commission to reach the following conclusions in its 1952 report on "Resources for Freedom":

(1) Any radical alteration of the existing tax arrangements would be undesirable; and

(2) No better alternative than percentage depletion would achieve the desired results without seriously dislocating well-established capital values and without highly adverse effects on supply.

Percentage depletion has become part of the economic structure of the industry. Supply, demand, and price have reflected the results of many actions taken by investors in risking many billions of dollars under the existing tax provisions. There is much to be said for the proposition that the differentials adopted by Congress have served the Nation well, and that no change should be made in the absence of compelling evidence that another course of action now will serve the public interest better.

The action of Congress in maintaining the same rate of percentage depletion through the years indicates a decision that this principle should be applied consistently, regardless of changes up or down in tax rates. The need for consistent application of this principle is most important when income tax rates are high, because such rates create the greatest threat to maintenance and expansion of capital investments necessary for economic progress.

There are several reasons why the established rate of percentage depletion appears to be no higher than needed.

First, return on investment and the rate of development of new resources is not excessive. During the past 6 years, petroleum exploration and drilling in the United States have declined substantially, and proved reserves of oil and gas have not increased as rapidly as demand. The ratio of proved reserves to current annual production is only about 12 to 1 for oil and 20 to 1 for gas, a relation that is adequate, but not excessive, in terms of expanding future needs.

Second, risks and replacement costs have been rising since World War II. Statistics of the American Association of Petroleum Geologists show that, in the search for new fields, the chances of making a commercially profitable discovery were cut in half between 1945 and 1956. New reserves of oil and gas per well drilled have decreased, while costs per well have increased, resulting in higher unit replacement costs.

Third, continued production and reinvestment in exploration and drilling has come to look less attractive relative to outright sales as percentage depletion has become an increasingly conservative measure of capital values. The record level of outright sales of producing properties reflects the judgment of experienced operators that the rewards on new ventures no longer appear commensurate with the risks, even under existing tax provisions. A cut in percentage depletion would swing the balance more heavily in favor of outright sales. Such a development would take funds away from exploration and drilling, thereby working to reduce future supplies.

Fourth, oil and gas are more important to our economy than ever before. They now supply three-fourths of the inanimate energy we consume, compared with only one-fourth in 1926. The petroleum industry has become a major sector of the economy, and its activities affect everyone as a consumer.

Fifth, oil is still highly essential for national security in preventing nuclear war. Even in the dire event of nuclear warfare, petroleum would be essential for immediate retaliation and for the ability of survivors to reconstruct an efficient economy after widespread destruction.

Finally, additional taxes on production must lead to higher prices if the industry is to attract sufficient capital to keep pace with the needs of an expanding economy.

The preceding analysis suggests that the long-established rate of percentage depletion is not too high.

The tax bill passed by the House of Representatives would require that aggregations authorized by the Revenue Act of 1954 be discontinued for petroleum after 1963, though they would continue to be allowed for other minerals. The Treasury Department estimates that the amount of additional taxes will be $40 million, which is equivalent to about 2 percent of the annual expenditures for drilling of new wells. If the change becomes effective, it will probably depress the level of drilling still further, with undesirable effects on the development of new reserves of oil and gas. Therefore, aggregation of properties within operating units should be continued in effect for all mineral industries, including petroleum.

Senator GORE. Mr. Chairman, may I ask a question there?

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Gonzalez, the provision of the law to which you have just made reference has promoted vertical organizations of the fuel industry—has promoted, I think, dangerous monopolies, particular tendencies, as well as to multiply the tax favors flowing therefrom.

As a consequence of this condition, though perhaps the House Ways and Means Committe may not find itself fully in agreement with my assessment of it, nevertheless as a general consequence of this problem, generally as I have stated it, I believe, the House com-

mittee recommended, and the House passed the provision which you now oppose. I notice in the House report that the committee has had great difficulty defining an operating unit. I wonder if you could help this committee in providing a definition of operating units in the petroleum industry.

Mr. GONZALEZ. An operating unit in the petroleum industry, in our accepted terminology, is one that is handled by common personnel; the same people are operating the wells, and this makes an operating unit.

Senator GORE. And you want to confine it to the well?

Mr. GONZALEZ. These people operate the wells and they operate the leases on which the wells are located.

Senator GORE. What about the refinery?

Mr. GONZALEZ. The refineries are not involved.

Senator GORE. I notice in the report here—before returning to the report, we understand that some companies have viewed a whole State, or a large portion of several States, as an operating unit. The present law permits them to include those leases and to exclude those leases in an operating unit which will make the 50 percent of net income limitation on percentage depletion have the least possible application.

As I understand the bill, it eliminates this broad concept of operating unit. You oppose that?

Mr. GONZALEZ. Senator Gore, the question of the size of an operating unit was raised by Secretary Dillon in his testimony before the Ways and Means Committee.

Senator GORE. You mean size financially or the multiplicity——

Mr. GONZALEZ. No; size in terms of the States as you mentioned. Some companies had said that an operating unit covered a State or portions of several States. This question of what is an appropriate unit is something that the Treasury Department can determine administratively under the rules established by Congress, and this will have to be settled in any event for the units that are authorized under the 1954 code.

Senator GORE. Well, if you—let me read from the report. I started to refer to it twice before and I would like to read it.

> Under existing law he—

that is the taxpayer in question here which is in this instance almost always a corporation—

> under existing law, he has the option to aggregate or combine any two or more operating mineral interests regardless of tract boundaries or number of deposits if they are within the statutory concept of an "operating unit" treating all such aggregation as combined into a single property.

Now, that states, perhaps more accurately, the situation which I described in the very beginning. But from this situation, without geographical boundary or without any differentiation between the producing well and the filling station selling at retail, with no legal boundaries for operating units, then the opportunity for tax advantages are very great. That is why I have asked you if you could give us a legal definition of what is an operating unit, or in case none is defined in the law, what in your opinion would be a proper definition or limitation of an operating unit under law?

Mr. GONZALEZ. Senator, aggregation applies only to producing properties and does not involve refining or marketing operations. The question of an operating unit, as I said before, is a unit operated by common personnel, and this applies to a geographic area.

Senator GORE. Well, I did win one fight in this area. Congress passed a law which stopped the application of percentage depletion on the value of the finished product.

You might be interested to know that this change was requested by President Eisenhower three times; the Secretary of the Treasury testified in behalf of it three times during the Eisenhower administration. I offered the amendment in this committee; it received two votes. I offered it on the floor of the Senate and was defeated, with the opposition of both the Democratic and Republican leadership, but immediately took the floor and offered it again and debated it at length, and we voted the next day and my amendment was passed 86 to nothing, 86 to 0, and became law.

Have you given us a definition or are you able to give us a definition on operating units?

Mr. GONZALEZ. I believe the definition I gave you, Senator, is one that you will find that the Internal Revenue Service of the Treasury Department accepts in its dealings with the oil companies.

Senator GORE. I don't believe that that is sufficiently definitive to answer the problem, if I may respectfully say so. Let me read you further from the House report:

> By 1954 the soundness of these earlier technical limitations respecting the term "property" as applied to the hard minerals became doubtful for a single mining operation cross tract boundaries to extract mineral deposits extending under adjacent or nearby tracts. In that year Congress by adopting the operating unit test allowed the aggregation or combination of such operating mineral interests in different properties operated as a unit to be treated as a single property.

This has been, of course, a continuing development, and as I understand the thrust of the House action, and the committee report, it has been to bring about what it regards as more reasonable limits to the legal term "operating unit."

Do you so understand that?

Mr. GONZALEZ. Senator, what I understand the House bill would do is to define a single lease in essence as a unit. You are aware, I am sure, of the fact that many times there will be a score of leases in the same field, and all of these leases may be operated by the same personnel and, therefore, they may well be a common operating unit.

Senator GORE. You oppose the provision in the bill in this respect?

Mr. GONZALEZ. Yes, we do.

Senator GORE. Thank you, Mr. Chairman.

Senator WILLIAMS. Mr. Gonzalez, the 27½ percent depletion allowance was started at a time when we had a 12½ percent corporate rate. Now, would you agree that a 20 percent depletion allowance with a 52 percent corporate rate would be far more advantageous than a 27½ percent with a 12½ percent corporate rate?

Mr. GONZALEZ. Well, it is a question of what you mean by advantageous.

Senator WILLIAMS. Advantageous to the oil companies. In other words, the higher the corporate ratings, does not the percentage depletion allowance become of a greater advantage?

Mr. GONZALEZ. The economic significance to the taxpayer is related to the rate, but the question of what Congress is intending to protect with the rate is a basic question.

As you know, percentage depletion was adopted in 1926 as an administratively simpler equivalent of discovery value. Discovery value was adopted in 1918 when the tax rate was much higher.

Senator WILLIAMS. What was the tax rate in 1918?

Mr. GONZALEZ. As I recall it was an excess profits tax rate that went very high at that time, Senator. I don't know the exact rate.

Senator WILLIAMS. But it was nowhere near the present rate, and in addition to that the 27½ percent rate was agreed upon in 1926, was it not?

Mr. GONZALEZ. As an equivalent of discovery value which was discovered in 1918.

Senator WILLIAMS. Now, I will go back to my question again.

From the financial standpoint of the company involved, is not a 20-percent depletion rate at a time when you have a 52-percent corporate rate of far more advantage than a 27½-percent depletion rate at a time when you had a 12½-percent corporate rate?

Mr. GONZALEZ. In terms of dollars and cents it is.

Senator WILLIAMS. Yes. Well, dollars and cents are what we really look forward to as the ultimate answer of making the determination, is it not?

Mr. GONZALEZ. Well, there is also the question of capital values, Senator.

Senator WILLIAMS. Yes. But the point I am making is, that, assuming the depletion rate was changed to 20 percent, it would still be of far greater advantage to the oil industry today than was the 27½-percent rate at the time it was first started from the dollars-and-cents standpoint.

Mr. GONZALEZ. There are many other changes that have taken place since 1926, too, Senator.

Senator WILLIAMS. Yes, some good and some bad but it still gets back to the question that I stated before, that from the dollars-and-cents standpoint of the earnings of the company involved the 20 percent rate today would still today be of far greater advantage and of far greater dollar incentive than was the 27½-percent rate at the time it was started.

Mr. GONZALEZ. Senator, I think you would find that the oil companies would be very happy if income tax rates generally were reduced back to the rates in 1926.

Senator WILLIAMS. I congratulate you on your ability to answer without referring to the original question. [Laughter.]

I won't press you for the endorsement of the 20 percent proposal, but I would suggest that sometime it may be well for the industry to consider the fact that the 27½ may be considered too high by the Congress and may be going to be changed, and I think that—I would like to see it done with the cooperation of the industry, rather than with the determined opposition of it.

Mr. GONZALEZ. Senator, I have had the pleasure of discussing this subject with you before, and I have endeavored in my prepared statement to give you some of the reasons why I think the rate is still correct.

Senator WILLIAMS. I appreciate it.
Senator GORE. Mr. Chairman, could I ask another question?
The CHAIRMAN. Senator Gore.
Senator GORE. Going back to your definition of an operating unit, I believe you said it should be confined to the unit which was operated, supervised, by the same personnel.
Do I remember correctly, do I state correctly your position?
Mr. GONZALEZ. Yes, that was essentially my statement, Senator.
Senator GORE. Well, with helicopters, private planes, an operating unit then could encompass the State of Texas, couldn't it?
Mr. GONZALEZ. It would be a matter of economics and depending on the location of some firm's particular operations it is conceivable that all of its production in the State of Texas might be one operating unit.
From my experience with the industry, I believe the larger companies would have a number of operating units in an area as large as Texas.
Senator GORE. But insofar as the law is concerned it could encompass the State of Texas if you have the definition that the same personnel are operating it.
Mr. GONZALEZ. I believe if the company actually operates all the properties with common personnel that is an operating unit.
Senator GORE. Then actually, with the improvement in transportation, acceleration of travel, this becomes almost meaningless as a limiting factor, because it could include not only Texas and Oklahoma and Louisiana but Tennessee, because a small supervisory personnel can fly from one to the other at various irregular periods.
So, this really ceases to be a limit or a definition at all.
Mr. GONZALEZ. Senator, there are obvious costs of transportation, and I don't believe that a company would find it advantageous to try——
Senator GORE. With the depletion allowance, the travel expenses of an executive of a company are not very significant.
Mr. GONZALEZ. I would beg to differ with you, sir. We are very cost conscious and we have worked very diligently in our industry in recent years to reduce our costs.
Senator GORE. I will accept that difference. It may be I am in error in this. I will come back to the substantive question. Would you be willing to accept, as a definition of an operating unit, a unit that is interconnected with pipes and pumps?
Mr. GONZALEZ. There have been considerations of different definitions of operating units, and one of them conceivably is leases in one field. A field is defined by regulatory orders, and this is a very clear-cut geographic definition.
Senator GORE. I offer this suggestion because I was contemplating your statement earlier, that in one field sometimes there are several leases.
Mr. GONZALEZ. Yes.
Senator GORE. Some, I think, in varying conditions overlapping another in certain conditions, I mean the conditions might overlap a geographic location of a well. Therefore, I have asked the question, whether to avoid that problem of having six operating units within one particular field, you would accept as a definition a field in which the pumps and the pipes are interconnected.

Mr. GONZALEZ. That would be one possible definition of an operating unit in the oil industry.

Senator GORE. Do you think that would be a proper and an acceptable definition?

Mr. GONZALEZ. In many respects, yes.

Senator GORE. Would you express the approval of the industry on that?

Mr. GONZALEZ. I cannot speak for the industry on that question.

Senator GORE. Thank you, Mr. Chairman.

Senator CARLSON. Mr. Chairman?

The CHAIRMAN. Senator Carlson.

Senator CARLSON. Mr. Gonzalez, I want to compliment you on the statement you have made here with respect to percentage depletion. It is not only one of the problems that concerns our committee and the Congress but it is one that concerns our people generally. We have had 37 years' experience, I believe. It was passed in 1926.

Mr. GONZALEZ. That is right, sir.

Senator CARLSON. What about our total reserves in 1926. What were the reserves in billions of barrels of oil in 1926? Are you familiar with that?

Mr. GONZALEZ. Senator, at that time the industry wasn't keeping a record of its proved reserves on a regular basis, as it does now. They were much lower at that time, than they are now, but I do not have any figure in mind that I can use as an official estimate of reserves.

Senator CARLSON. Well, I have some figures before me that—I do not know that they are accurate, but it states in 1926 we had 8 billion barrels of oil in reserves. Do you think that might be somewhere near right?

Mr. GONZALEZ. That might be approximately correct.

Senator CARLSON. What would you say the reserves would be in 1963?

Mr. GONZALEZ. The proved reserves of crude oil in 1963 are approximately 32 billion barrels.

Senator CARLSON. In other words, under this program we have been operating we have had an increase in our proven reserves?

Mr. GONZALEZ. We have.

Senator CARLSON. What about the price of gasoline in 1926, gasoline less taxes?

Mr. GONZALEZ. The price of gasoline less taxes in 1926 was a little higher than the price of gasoline less taxes is currently.

Senator CARLSON. Would 20.9 cents per gallon be right in 1926?

Mr. GONZALEZ. I believe it was higher than that, Senator.

Senator CARLSON. I have some tables that have been given to me. I don't know whether they are accurate. But that is the figure I have for 1926. It states gasoline less taxes sold for 20.9 cents per gallon in that year. What about 1963?

Mr. GONZALEZ. I have some figures that I can refer to, if you wish.

Senator CARLSON. I would like to have them. Gasoline less taxes.

Mr. GONZALEZ. The retail gasoline price of regular grade gasoline in 50 cities as reported by the American Petroleum Institute averaged last year, 1962, 20.36 cents excluding tax. The comparable figure in that series for the year 1926 is 20.97 cents.

Senator CARLSON. That was for 50 cities?

Mr. GONZALEZ. For 50 cities.

Senator CARLSON. In other words, for 37 years operating under the present 27½-percent depletion, the gasoline price per gallon to the consumer is actually less than it was 37 years ago?

Mr. GONZALEZ. That is correct, sir.

Senator CARLSON. I don't believe there is any other phase of our economy in which you could make that statement regarding the selling price of a commodity.

What about the amount of gasoline that an individual could purchase based on an hour's labor, in 1926? How much gasoline, based on your figures there, would you say that a consumer could purchase based on an hour's labor?

Mr. GONZALEZ. I don't have the figure in mind for 1926, but I know that the average earnings in manufacturing have increased very substantially, and, therefore, that the amount of gasoline that a worker can buy with the pay for an hour's work has increased very sharply.

Senator CARLSON. This same table that I have before me states that in 1926 1 hour's wages would buy 2.6 gallons of gasoline. In 1960, and I do not have the 1963 figures but it would be approximately the same, 1 hour's wages would buy 10 gallons of gasoline.

The point I wanted to make with these two or three illustrations is this: That 37 years of operations under the present depletion laws have not only increased our oail reserves, it has held the price of gasoline down, and it has also been of great benefit to the consumer in addition to keeping our Nation prepared in national emergencies, not only furnishing the energy for the domestic economy but for defense; and I appreciate very much your statement.

Mr. GONZALEZ. Thank you.

The CHAIRMAN. Any further questions?

Senator Douglas?

Senator DOUGLAS. Mr. Decker, do I understand that you represent the Independent Petroleum Association that has 6,000 independent oil and gas producers?

Mr. DECKER. I do.

Senator DOUGLAS. Do your members have refineries? Do you sell petroleum to refineries owned by others?

Mr. DECKER. We do. We have members who are also refiners and marketers.

Senator DOUGLAS. What proportion of your members have refineries? What proportion simply own fields and sell to refineries owned by others?

Mr. DECKER. You are asking in numbers?

Senator DOUGLAS. Yes.

Mr. DECKER. I would say that over 90 percent of our members, as numbers of members, are independent producers only.

Senator DOUGLAS. And do not own refineries?

Mr. DECKER. Do not own refineries.

Senator DOUGLAS. Of the 10 percent or less who do own refineries, what percentage of the total production of all of the members is comprised in those organizations?

Mr. DECKER. I am not clear on your question.

Senator DOUGLAS. Well, you say that over 90 percent do not, of your members do not, own refineries.

Mr. DECKER. Yes.

Senator DOUGLAS. This would mean that 10 percent or less, and I would like to have you supply for the record what the present size figures are, that 10 percent or less do own refineries.

Mr. DECKER. Yes; it is less than 10 percent. In fact, only 2 percent of our members own refineries.

Senator DOUGLAS. Now, I ask what percentage of the oil produced by all of your 6,000 members is produced by the 10 percent who own refineries?

Mr. DECKER. I do not have that figure in mind.

Senator DOUGLAS. Could you make an estimate?

Mr. DECKER. I think it would be best if we furnish it for the record rather than make an estimate.

Senator DOUGLAS. Yes.

Mr. DECKER. I would say that approximately over 90 percent of our members, as numbers of members, comprised of independent producers only.

Senator DOUGLAS. And do not own refineries?

Mr. DECKER. Do not own refineries.

Senator DOUGLAS. Of the 10 percent or less who do own refineries, what percentage of the total production of all of the members is comprised in those organizations?

Mr. DECKER. I am not clear on your question.

Senator DOUGLAS. Well, you say that over 90 percent do not—of your members, do not—own refineries.

Mr. DECKER. Yes.

Senator DOUGLAS. This would mean that 10 percent or less, and I would like to have you supply for the record what the present size figures are, that 10 percent or less do own refineries

Mr. DECKER. Yes.

Senator DOUGLAS. Now, I ask what percentage of the oil produced by all of your 6,000 members is produced by the 10 percent who own refineries.

Mr. DECKER. I do not have that figure in mind.

Senator DOUGLAS. Could you make an estimate?

Mr. DECKER. I think it would be best if we furnish it for the record rather than make an estimate.

Senator DOUGLAS. You can't make an estimate?

Mr. DECKER. I would not hazard a guess because it would be strictly a guess.

(The following was later received for the record:)

After checking I find the following to be the facts pertaining to our members who have refining facilities: Of the total membership of our association of approximately 6,000, about 50 members are engaged in refining. These refining members in total produce something less than 15 percent of total U.S. oil production.

Senator DOUGLAS. Have you had a chance to look over the exhibits on the depletion allowances and the exploration and development costs which the Secretary of the Treasury submitted to the House Ways and Means Committee on February 6 of this year?

Mr. DECKER. Yes, sir.

Senator DOUGLAS. And which are found in the first volume of the House hearings beginning at page 278 and continuing for some pages thereafter.

Mr. DECKER. I have read that testimony.

Senator DOUGLAS. Good.

Do you remember that the Secretary of the Treasury stated that in the year 1960 that total depletion claims of $3.3 billions were made by corporations. That is on page 293.

Mr. DECKER. Your reading is correct.

Senator DOUGLAS. And more than two-thirds of this total were claimed by corporations in two industries; namely, crude petroleum extraction and petroleum refining.

Mr. DECKER. That is the companies that produce this crude oil?

Senator DOUGLAS. It was in two industries, crude petroleum extraction and petroleum refining.

Mr. DECKER. Depletion would only apply to production.

Senator DOUGLAS. I know, but petroleum refining companies also own crude petroleum properties, don't they?

Mr. DECKER. Yes.

Senator DOUGLAS. Well, that is the point.

Mr. DECKER. Yes.

Senator DOUGLAS. The classification by corporations cover both branches, but refer to the extraction of petroleum and gas.

In other words, your industry obtained a tax credit of $2,200 million—slightly more than that—in 1960.

Mr. DECKER. That is right—a tax deduction.

Senator DOUGLAS. Which is about twice what it obtained in 1952, I think.

Mr. DECKER. I don't have the figures in front of me.

Senator DOUGLAS. I think that is correct.

This has resulted, has it not, from the fact that the petroleum industry pays a much smaller fraction of its net income in taxes to the Government than virtually any other industry in the United States?

Mr. DECKER. The overall—the petroleum industry, pays as much or more taxes.

Senator DOUGLAS. I am speaking percentage of net profits, not total in dollars but percentage of net profits. Isn't that true?

Mr. DECKER. Of the total tax, you are counting State taxes, excise taxes?

Senator DOUGLAS. No, no. Of the net profits made by companies engaged in the extraction of petroleum and natural gas, is it not true that the rate of taxation for those companies is lower than for any other industry in the United States?

Mr. DECKER. I don't know—I am not prepared to answer that.

Senator DOUGLAS. It is a plain matter of fact, and it emerges from these tables with which you are acquainted.

Do you think one industry should be given this great advantage?

Mr. DECKER. I don't consider it in advantage. I consider it desirable.

Senator DOUGLAS. You mean you deny that your rate of taxation is lower than for other industries?

Mr. DECKER. Senator, I say I do not consider it an advantage. I consider it desirable from the Nation's standpoint that the industry have the 27½-percent depletion.

Senator DOUGLAS. Even though it results in less income to the people of the United States and even though it probably leads, and it does

lead indeed, to overinvestment in the oil industry and, therefore, to an improper allocation of resources.

Mr. DECKER. I do not consider that correct.

Senator DOUGLAS. Why isn't it?

Mr. DECKER. I think the petroleum industry by its very action, by the pricing of its products, indicates that it does not have an advantage. When you can buy gasoline today—less tax—less than you could buy in 1926, this industry has apparently conducted itself in a manner which I think is to the benefit of the consumer.

Senator DOUGLAS. I am speaking of the question of taxes. You are answering on something entirely different.

Mr. DECKER. I think it all devolves around the fact, plus the fact that it is very important to keep in mind the national defense aspect in the production of crude oil and refining of crude oil. If we become dependent on foreign sources for oil we may see the price of gasoline and the price of crude oil soar.

The greatest deterrent and benefit that the consumer has is having the industry strong in the United States, with the ability to find and produce oil and pass on to the consumer the benefits which he now enjoys.

Senator WILLIAMS. Will the Senator yield?

Senator DOUGLAS. Yes, I will be happy to yield.

Senator WILLIAMS. That same statement could be made in connection with any other industry operating in America, could it not?

Mr. DECKER. Senator, not to this extent. When we search for crude oil or for natural gas, it is not like building a building or a factory in which you can count the bricks and mortar and see it and see the output from your factory. We strive and we try to find a product that is unknown from the surface, and our failures as Dr. Gonzalez showed was 38 percent dry holes in 1960—was it 1960—so that is a high-risk factor, and when you have a high-risk business, you have to have some incentive in order to have the public go back and reinvest in that business.

You take away depletion—or increase the risk—and you will have nobody out here looking for oil, which is highly essential.

Senator WILLIAMS. I will narrow it down. That same statement could be said in connection with American agriculture?

Mr. DECKER. Sir?

Senator WILLIAMS. That same statement could be made in connection with American agriculture as to its importance to our economy in event of peace or war.

Mr. DECKER. That is true.

Senator WILLIAMS. And to the fact that it is a risk operation.

Mr. DECKER. That is true. On the other hand, American agriculture has been subsidized, and the petroleum industry is not.

Senator WILLIAMS. Of course, there are those who think that the subsidies on American agriculture, as well as the depletion have both been overextended and the time may be arriving when we should change both.

Senator DOUGLAS. Mr. Decker on pages 306 and 307 of the House report the Secretary of the Treasury has submitted evidence which shows that in 1958, which is the most recent year for which we have figures, the depletion allowances and the amount therefore freed from

taxation amounted to 39.6 percent of the net income of companies exclusively engaged in the crude petroleum and natural gas business, and 48.2 percent of companies incorporated as primarily petroleum refining companies. Without any real violence to the facts, somewhere between 40 and 50 percent of the net income from the mineral properties or the oil properties of these companies was freed from taxation by the 27½-percent depletion allowance.

Mr. DECKER. If those were the figures the Secretary compiled why they must be accurate.

Senator DOUGLAS. Don't you think they justify action by the Congress?

Mr. DECKER. I do not.

Senator DOUGLAS. You do not.

Do you think they should be extended then to grant 27½-percent allowance instead of 23 percent to the sulfur industry?

Mr. DECKER. I am not prepared to answer it for the sulfur industry.

Senator DOUGLAS. Well, you see you have this high ratio, why shouldn't sulfur have it?

Mr. DECKER. I am not objecting to it for the sulfur industry.

Senator DOUGLAS. Why not clam shells and oyster shells which were inserted in the depletion in 1951?

Mr. DECKER. I have no objection, I know nothing about it.

Senator DOUGLAS. You would be ready for the 27½ percent for them?

Mr. DECKER. I have no knowledge of those industries.

Senator DOUGLAS. Or——

Mr. DECKER. Or to say whether that is a correct figure.

Senator DOUGLAS. Or stone, clay, and gravel.

Mr. DECKER. I know they all have depletion.

Senator DOUGLAS. But not as much as 27½ percent.

Now, just a moment on your members, what is the average volume of business done by your members?

Mr. DECKER. I cannot answer that.

Senator DOUGLAS. It would seem to me to be a very fundamental fact. You have got 6,000 producers, what is the total volume of business done?

Mr. DECKER. I do not have that within my knowledge because they are individual members. Most of them are, a large majority are very small individual members.

Senator DOUGLAS. A large majority have gross incomes of less than a million?

Mr. DECKER. Oh, yes.

Senator DOUGLAS. Do many have incomes over $5 million?

Mr. DECKER. Yes.

Senator DOUGLAS. Many?

Mr. DECKER. Not in large numbers.

Senator DOUGLAS. But some. Are you acquainted with the proposal which I have advanced various years, namely, that for companies or concerns with a gross income of less than a million dollars that the 27½ percent depletion allowance be continued, but that on concerns with gross incomes from $1 to $5 million that the rate be reduced to 21 percent, and on concerns with a gross income of more than $5 million that the rate be reduced to 15 percent.

Are you acquainted with that proposal?

Mr. DECKER. Slightly, yes.

Senator DOUGLAS. Well, since you have said that the vast majority of your members have gross incomes much less than a million this proposal would not diminish in the slightest the returns to the vast majority of your members.

Mr. DECKER. That is true; it could be.

Mr. DOUGLAS. Why don't you pitch in and support us, and support me? [Laughter.]

Mr. DECKER. Simply because we do not believe that that is the correct manner in which to operate in this industry.

Senator DOUGLAS. Or is it that the big companies really control your independent oil producers and the independent oil producers are scared to death of getting in the bad graces of the 10 or 12 big producers?

Mr. DECKER. No; we are not scared to death.

Senator DOUGLAS. But somewhat frightened; is that true?

Mr. DECKER. No; I don't believe the average producer is frightened about the big company. I believe he feels he can compete against the big company. There isn't any producer, though, who wouldn't like to have sales of over a million, $5 million, $10 million.

Senator DOUGLAS. I know, but the number who have reached that point is relatively limited.

Mr. DECKER. Yes; but the average person.

Senator DOUGLAS. You mean hope is stronger than reality?

Mr. DECKER. Yes.

Senator DOUGLAS. You want to cash in on hope rather than reality?

Mr. DECKER. No; there is always hope, too, when you drill a well, hope to produce. With all the facts you have you still do not know whether it will produce.

Senator DOUGLAS. Do any of your companies own filling stations?

Mr. DECKER. Yes.

Senator DOUGLAS. They do.

Are you aware that independent filling stations are put at a disadvantage with the filling stations owned and controlled by the big oil producers because the big oil producers are subsidized by the depletion allowance and, therefore, can engage in price wars which make it more difficult for the independent filling station to survive?

Mr. DECKER. I disagree with that, Senator.

Senator DOUGLAS. What?

Mr. DECKER. I disagree with that.

Senator DOUGLAS. Well, the big companies get the big tax credits, and, therefore, retain a larger share of their profits, certainly a larger share than the small company which only has a few or one filling station, and, therefore, the large companies can subsidize a rate war in the distribution end with the taxes which it doesn't pay on the producing end.

Mr. DECKER. I know no one who condones or likes price wars regardless of the size of the company.

Senator DOUGLAS. What?

Mr. DECKER. I say, I know of no one who likes or condones price wars regardless of the size of the company.

Senator DOUGLAS. Big companies frequently do that.

Mr. DECKER. They do. It occurs, we understand.

Senator DOUGLAS. And they are subsidized in this by the profits which they retain because of the 27½-percent depletion allowance.

Mr. DECKER. I do not concede that.

Senator DOUGLAS. It is a fact. I hope you independent oil producers will show some independence sometimes. I think you ought to have a declaration of independence. [Laughter.]

I would be very happy to draw one up for you.

Mr. DECKER. Thank you, Senator.

Senator DOUGLAS. But it is very hard to give freedom to people who will not strive for it.

The CHAIRMAN. Senator Morton?

Senator Talmadge?

Senator Dirksen?

Senator CARLSON. Mr. Chairman.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. Just following the suggestion that the Senator from Illinois, Senator Douglas, made, would it not be the establishment really of a graduated corporation tax based on size or bigness and the tendency, of course, if that were approved would be for these large corporations to gradually split up into smaller units; wouldn't that be the tendency?

Mr. DECKER. I think you would find the smaller individual once he gets past a certain stage would immediately sell out.

Senator CARLSON. In other words—well, yes, of course, that is what would happen, I assume.

Mr. DECKER. It is happening fast enough now and you would really accelerate it if you had that.

Senator CARLSON. That is all.

Senator DOUGLAS. Would the Senator yield?

Senator CARLSON. I am through.

Senator DOUGLAS. Do you think they would sell out?

Mr. DECKER. I say if the depletion came to 20 percent instead of 27½ percent by the graduation that you propose, they would immediately sell out.

Senator DOUGLAS. Why?

Mr. DECKER. Because the lower depletion rate that they would have after they got past a certain stage, they would sell out. The capital gains would be a greater encouragement for them to sell. My income, if it is a million dollars under your proposal, I would have 27½ percent.

Senator DOUGLAS. That is right.

Mr. DECKER. If my income became $5 million, I would be graduated down to 20 percent.

Senator DOUGLAS. 15 percent.

Mr. DECKER. 15, all right.

Senator DOUGLAS. Between 1 and 5 million, 21 percent.

Mr. DECKER. Why should I remain in business having seen—had depletion at 27½ percent, seen it go down to 15 percent. I would sell out.

Senator DOUGLAS. Well, to whom would you sell?

Mr. DECKER. I would sell to whoever would buy.

Senator DOUGLAS. You would sell out to the large companies?

Mr. DECKER. You would have to, they are the buyers.

Senator DOUGLAS. Not at all, because if you have the large companies then the earnings of the small property would be lumped with the earnings of the large property and rates would go up. In the amendment that I propose the problem of multiple ownership and aggregate ownership is recognized; they have to be bona fide independent concerns with businesses less than a million and not merely appendages of giant companies with aggregated properties over 5 million.

Mr. DECKER. But you would sell, once your income became over a certain level you would certainly sell.

Senator DOUGLAS. To another man who had a low gross income.

Mr. DECKER. No, you would sell to a larger unit.

Senator DOUGLAS. The larger unit wouldn't buy if it had to pay more in taxes, if it suffered a tax disadvantage because of size.

Mr. DECKER. Under your law they would already be at that rate. What you could do, too, is you could force the small individual who would want to grow, to become static, rather than to get beyond a certain income basis.

Senator DOUGLAS. This would still allow everyone 15 percent. You know if you don't make some concessions some day the conscience of the country is going to revolt, and either everyone will go down to 15 percent or the whole system of depletion allowances will be swept away. And one of the sad things is the way your people won't recognize this until it is too late.

Mr. DECKER. Senator, I disagree, because I think from the consumer standpoint the oil industry has served the consumer well.

Senator DOUGLAS. I am not denying that. But I am speaking from the tax standpoint.

Mr. DECKER. Isn't that for the benefit——

Senator DOUGLAS. I don't want to conduct this dialog at too great length. But here you have Uncle Sam losing $3.3 billion in taxes, and the rest of the taxpayers being compelled to pay a higher rate because you folks are getting a special advantage, and of that $3.3 billion $2.2 billion is chargeable directly to the oil industry and possibly more, because there may be financial companies that are getting into this.

Now, the result is that you pay a rate of taxation probably only about half that of other corporations and concerns and I have put into the record examples of concerns which have made huge profits over 5 years but have paid almost no taxes. One company earning $65 million net over 5 years didn't pay a cent in taxes, and got a $235,000 refund. There are cases of individuals receiving incomes of millions of dollars over a period of years who do not pay anything in taxes.

Mr. DECKER. Of course, there are extremes in any industry. The thing I think you forget is once you change this 27½ percent, you talk about the $3 billion which is a deduction—not a tax loss figure—the $3 billion will not be there, because this industry would gradually go downhill. The independent will not be out drilling and finding new oil. It would be less attractive to him. There will be no incentive for anybody to come into this industry from the outside.

So, you will have a drying up of capital in this industry, and that will continue to a point where you will be putting back the 27½ percent or even higher in order that we might explore to find oil in these United States.

Senator DOUGLAS. Some years ago, we had Professor Harberger testify before our Joint Economic Committee. He want to testify before us on the pending bill but he had a heart attack and was unable to appear. His testimony at that time was that the depletion allowance had induced overinvestment in the gas and oil industry and, therefore, had led to a misapplication of both capital and labor. Because of the tax advantage it had drawn both labor and capital away from other lines of industry into the oil industry.

I know people in the gas and oil industry don't believe that, but it is a sober fact.

Mr. DECKER. I can't agree.

Senator DOUGLAS. Thank you, Mr. Chairman. No further questions.

Mr. GONZALEZ. May I complete my statement?

Taxpayments of the petroleum industry. Minerals are taxed differently from other industries by State and local governments as well as by the Federal Government. Severance and property taxes on petroleum operations in the United States average about 21 cents per barrel and represent approximately 7 percent of gross revenue.

State and Federal gasoline taxes, which now average more than 10 cents a gallon, yield revenues in excess of $6 billion annually, equivalent to 75 percent of the gross value of crude oil produced in the United States. Not all of this burden can be justified on the benefit theory, since some States divert part of these revenues to nonhighway purposes and since part of the cost of highways should be financed from general revenues because of the benefits they provide for defense and for the general public. Thus, the combined effect of special burdens on domestic petroleum operations caused by severance and gasoline taxes together is quite large in relation to the value of crude oil production.

Statistics are not available on taxpayments of the producing operations of the domestic petroleum industry alone, but a study has been made comparing the total taxpayments of the petroleum industry with those of other industries by the Petroleum Industry Research Foundation.

This study shows that for 1959–61 25 large oil companies with operations primarily in this country paid excise and sales taxes averaging $2.4 billion annually and other taxes averaging $657 million. Excise taxes were 17 percent of gross revenue for these companies and other taxes were 5 percent of gross revenue.

For manufacturing corporations, exclusive of the beverage and tobacco industries, taxpayments in the 3-year period 1959-61 averaged 5.1 percent of gross revenue. These figures show that the proportion that total taxes represent of gross revenues is about the same for petroleum as for manufacturing generally if excise and sales taxes are excluded, and much higher if any significant part of the excise taxes are included.

Any consideration of tax revenues generated by petroleum operations should also take into account the favorable influence of oil and gas supplies on general economic progress. In stimulating the growth of our economy, petroleum has also contributed to a general expansion of national income and to the revenue generated by the tax system. Only a modest gain in the general rate of economic growth as a result

of the provisions that have encouraged investment in petroleum production could mean far more tax revenue than the amount which might be realized temporarily by heavier taxes on petroleum production.

The preceding considerations lead me to the conclusion that additional taxes on petroleum production would not be consistent with the objective of chaging the tax laws in a manner that will stimulate economic progress and prosperity. I believe that the differential tax treatment of petroleum in effect for many years has contributed materially to national progress and security and should be continued in effect without change.

(The full prepared statement of Mr. Gonzalez follows:)

STATEMENT ON TAXATION OF PETROLEUM PRODUCTION BY RICHARD J. GONZALEZ, DIRECTOR, HUMBLE OIL & REFINING CO., HOUSTON, TEX., IN BEHALF OF AMERICAN PETROLEUM INSTITUTE, MID-CONTINENT OIL & GAS ASSOCIATION, ROCKY MOUNTAIN OIL & GAS ASSOCIATION, AND WESTERN OIL & GAS ASSOCIATION

Taxation is such a complex subject in theory and in practice that it is not surprising to find substantial differences in views as to the merits of various provisions of the tax laws. The income tax provisions relating to petroleum production, particularly percentage depletion, have been the subject of considerable debate and have been examined by Congress many times in the past. While the bill recently passed by the House contains changes for petroleum relating only to the aggregation provisions adopted in 1954, a discussion of the considerations relevent to the more basic and long-established differential tax provisions for petroleum may serve to clarify the issues involved.

CONTRIBUTIONS OF PETROLEUM TO PROGRESS AND SECURITY

The United States enjoyed a significant leadership in the development of petroleum resources in the first half of the 20th century. This leadership has been of the greatest value to the Nation. Oil and gas have provided the energy for the remarkable development of the United States during the past 50 years. They have literally brought us from the horse and buggy days to the jet age; they have made possible mechanization that increased productivity in agriculture and industry, and they have provided heat for many comforts in the home.

The National Fuels and Energy Study prepared for the Senate Interior Committee in 1962 called attention to the close relationship between energy consumption and real national income per capita in the United States during the past 32 years.[1] It shows that we use about 240 million British thermal units of inanimate energy per capita in achieving real income of about $2,300 per capita. In other words, it takes about 100,000 British thermal units, equivalent to 100 cubic feet of natural gas, or about two-thirds of a gallon of crude oil, to provide the energy base for a dollar of income. Without abundant quantities of inanimate energy to run the machines that enable our society to produce more than ever before with less physical effort and shorter hours of work, our standards of living could not be maintained.

Petroleum has contributed to our security not only by increasing our economic strength but also by providing the fuel for our military forces. In World War II, more than half of all the tonnage shipped to our military forces consisted of petroleum products, and most of the explosives for Allied bombs came from petroleum. In subsequent emergencies (such as the Korean conflict, the closing of the Suez Canal, and the Cuban crisis), as well as throughout the cold war, oil produced by American companies has added to our security. Even with the development of nuclear weapons, petroleum continues to be necessary for our military strength. Since we wish to avoid the massive destruction of nuclear warfare, we must be prepared to fight effectively by conventional methods in order to protect ourselves and friendly nations against aggressors who will not hesitate to take advantage of any deterioration in our ability to conduct conventional military operations. Even in the dire event of a nuclear war, petroleum

[1] National Fuels and Energy Study, report to the Senate Committee on Interior and Insular Affairs, 1962, p. 30.

would be essential for immediate retaliation and for the ability of survivors to recover from widespread destruction.

In testimony before the Joint Economic Committee last February, Under Secretary of the Interior Carr made two important points: (1) That the economic strength of this Nation is, to a large extent, the result of effective utilization of large quantities of low-cost inanimate energy; and (2) that in order to continue its enviable record of economic growth the United States should take all the steps necessary to insure that abundant low-cost sources of energy will continue to be available.[3] In my judgment, the differential provisions for minerals in the income tax laws relating to depletion and intangible development costs have played an essential role and will continue to be necessary in bringing forth the supplies of energy required for economic progress and national security. The Nation and all of its people benefit greatly from these differential tax provisions.

BASIC REASONS FOR DIFFERENTIAL TAX TREATMENT OF MINERALS

Since income taxes were first introduced, our laws and regulations have recognized special problems involved in the taxation of the mineral industries. These problems arise from peculiar circumstances that distinguish the extractive industries from other forms of economic activity.

In manufacturing, utilities, retail trade, real estate, and many businesses other than mining, new investments are made as a result of studies indicating how much it will cost to create a specified amount of new capacity and that such action can be expected to result in a reasonable profit. These calculations can be made with sufficient accuracy in most cases so that, as a general rule, the value of such facilities when they are placed in operation will be closely in line with cost. In these circumstances, an allowance for depreciation based on cost will enable the owner to maintain his capacity by reinvestment of depreciation charges provided inflation does not alter replacement costs.

In the mineral industries, by contrast, operators are faced with different conditions. Seldom can they tell in advance how much it will cost to discover and develop a specified amount of new resources. Indeed, large sums must usually be risked in exploration in an effort to locate deposits that can be tested to determine whether commercial development is feasible. In the case of the petroleum industry in the United States, for example, annual expenditures for exploration exceed $2 billion a year, including the cost of dry holes. Of the wells drilled in the search for new fields, only about 2 percent locate commercially profitable discoveries that will return more than their total costs for exploration, development, and production. Against these odds, about 9,000 exploratory wells are drilled currently in the United States in an effort to replace oil and gas produced annually. Even after a field is discovered, many dry holes are drilled in the process of defining the limits of the productive area. In total, the petroleum industry experiences about 17,000 dry holes annually out of about 44,000 total wells, which means that 38 percent of all wells drilled prove to be nonproductive.

The formidable risks of petroleum exploration and drilling have important economic consequences. First, the unusually heavy losses experienced in this industry require the prospect of a higher rate of return to attract funds into this business than into ventures with less risk. The business of developing new petroleum resources is considered so risky as to call for a premium in case of success above the results that can be realized with greater certainty in other business. The need for such premium is recognized in economic theory and consistent with the importance that investors place on protection of their capital against serious loss. The fact that some people are willing to gamble modest sums does not mean that enough funds would be available from such sources to finance large outlays required in petroleum exploration. The second major point is that cost and value are rarely equal on individual ventures, contrary to the usual experience with other investments. Thousands of ventures result in total loss of all the funds risked, some result in modest gains, and in a few spectacular cases, which always seem to be the ones that attract attention, the values generated are many times the initial outlay. In case of failure, losses can be charged off against taxable income, and that reduces the net cost of the venture, but there is still a net out-of-pocket cost as against not undertaking the venture at all.

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[3] Development, Growth, and State of the Atomic Energy Industry, hearings before the Joint Committee on Atomic Energy, Feb. 20 and 21, 1963, pt. 1, p. 91.

Losses can be written off in determining taxable income in this business, as in others, but this fact cannot in itself make risk taking attractive, since no profit can be realized from a failure.

Another characteristic of the search for minerals is the relatively long time-lag between the initiation of an exploratory program and the realization of substantial production even in case of success. This interval of 5 to 10 years for major ventures, such as the offshore area of the Continental Shelf, means that conditions may be quite different by the time the properties begin to pay off from those anticipated when the venture started. Because the nature of the business makes it impossible to control the rate of development of new capacity, mineral ventures are characterized by erratic changes in the relation of capacity and demand which affect operating rates, prices, and profitability. In the case of petroleum, for example, the shortages encountered in the early postwar years brought about a sharp rise in exploratory efforts, many of which did not begin to pay off until about 1958, by which time both prices and the ratio of production to capacity were declining. Therefore, profit margins realized proved to be considerably different from those anticipated when decisions were made to undertake expensive new ventures. Circumstances of this nature let the President's Materials Policy Commission to conclude in its report of 1952, "Resources for Freedom,"[3] "that incentives provided through the price structure are unlikely to bring about exploration and development to meet national needs for domestic production of scarce minerals."

The extractive industries must also contend with diminishing returns. Even during periods of relatively stable prices, during which other industries find that depreciation charges are enough to pay for the wear and tear on their capital equipment, mining industries find it increasingly expensive to develop new resources as they extend the margin of operations to poorer prospects that entail higher costs per unit. In times of inflation, the amounts recovered by writing off costs on past successful ventures fall seriously short of providing funds required to replace mineral reserves depleted by production.

Petroleum production is also very capital intensive, requiring several times as much investment per dollar of annual sales as the average for manufacturing industries. As a result, the profit per dollar of sales must be larger in petroleum production than in manufacturing to yield the same rate of return per dollar of investment.

The basic characteristics of minerals in general, and of petroleum in particular, create problems when income taxes are imposed. The first difficulty arises in measuring capital. As noted previously, cost and value for individual properties differ widely. Therefore, cost does not provide a satisfactory measure of decline in capital value and of the funds required to replace production. To measure the decline in capital worth incident to depletion caused by production, we must look to the value of the reserves produced rather than their cost. Unless this is done, the industry will be in the position of paying income taxes on sums that must be kept in the business in order to maintain operations without a decrease in the reserves that constitute its basic assets.

The unusual burden of income taxes on industries that are risky and capital intensive must also be take into account. If in the absence of income taxes two industries require rates of return of 10 percent and 15 percent, respectively, because of different risks, then the imposition of a 50 percent income tax will require a rise in price to maintain the same return after taxes of 10 cents and 15 cents, respectively, per dollar of investment if capital intensities are the same. In this case, the income tax burden on the risky industry will be 50 percent greater per dollar of sales than on the other industry. In addition, if the risky industry is twice as capital intensive as the other, then the tax burden per dollar of sales will be three times as much. Such circumstances would make it harder to sell the products of the risky industry and cause too little capital to be attracted into it when income taxes are imposed. In economic terms, the imposition of uniform income taxes on industries with widely different rates of return and capital intensity would distort the allocation of capital from that which would be determined by price alone in the absence of income taxes. Therefore, differential income tax treatment is needed for mineral production in order to avoid placing it as a disadvantage in attracting capital. Since the early days of income taxes, such a differential has been provided by Congress through depletion.

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[3] The President's Materials Policy Commission, "Resources for Freedom, Foundations for Growth and Security," June 1952, vol. 1, p. 34.

PERCENTAGE DEPLETION

When income taxes were first imposed, it became necessary to decide what measure should be used to compute depletion in determining taxable income. Because of the nature of the business, it was recognized that cost depletion would fall short of the real decline in capital value for most properties. On the other hand, in cases of poor success, or in case of purchase of an established producing property, cost depletion could represent a large portion of the total proceeds realized subsequently from production. In the original income tax law, Congress recognized the values of existing assets as a basis for computing capital allowances in determining taxable income if they differed significantly from cost. In 1918, Congress decided that fair value at the time of discovery provided a reasonable measure of capital exhausted by production of minerals and that this measure should be used in determining taxable income if it exceeded cost depletion. Discovery value depletion applied to all mineral production.

The 1918 law required that discovery value be determined for each new producing property. In the case of petroleum, there were thousands of properties involved each year, and formidable administrative problems were encountered because of differences in appraisal of value by taxpayers and the Government. In an effort to solve these problems, a study was made by the Treasury Department and Congress. This study showed that appraisals agreed upon for reserves in the ground were related to the current price of crude oil as produced at wells. This relation suggested the idea of depletion based on a percentage of the gross revenue as an equivalent of discovery value that would be much simpler and easier to administer. The two houses of Congress considered 25 percent and 30 percent of gross revenue as the appropriate figure, and compromised on 27.5 percent as a measure which approximated the depletion actually taken under the discovery value principle adopted in 1918. The limitation of depletion to 50 percent of the net difference between revenues and costs excluding depletion continued in effect. Since 1926, provisions for percentage depletion on petroleum have remained the same throughout many changes in tax rates up and down.

The transition from discovery value depletion to percentage depletion for other minerals was made subsequently, beginning with coal, metals, and sulfur in 1932. All minerals are subject to the same limitation of not more than 50 percent of net income before depletion. The rate of depletion based on gross income varies from 5 percent for sand, gravel, and oyster shell up to 10 percent for coal, 15 percent for clay and most metals, 23 percent for sulfur, uranium, and some strategic metals, and 27.5 percent for oil and gas. These variations appear to reflect such factors as (1) relative scarcity, (2) costs and risks of exploration, (3) importance to the economy and to national security, and (4) the relation of net income to gross revenue. It is worth noting that in case of wide differences in the relation of gross revenue to invested capital, substantially different percentages of depletion based on gross revenue may result in about the same figure arrived at under the limitation to 50 percent of net income before depletion. For example, a mining property with a dollar of sales per dollar of invested capital and a net return before depletion and before income taxes of 20 percent could not utilize effectively a depletion rate in excess of 10 percent of gross revenue, because the deduction could not exceed 50 percent of net before depletion, or 10 cents. On the other hand, a property in another mineral industry with the same return on investment but twice as much capital invested per dollar of sales would need a depletion rate set at 20 percent of gross revenue to achieve the same result authorized by the limitation based on net income. Raising the rate on gross revenue for the first property would not increase its depletion because of the 50-percent limitation. On the other hand, cutting the rate on gross revenue for the second property to the level appropriate for the other would mean that the effective rate for the second would drop to 25 percent of net before depletion, whereas the less capital intensive property would continue to realize depletion equal to 50 percent of net before depletion.

The rate for petroleum was set first as a result of careful study, and the other rates were set subsequently taking into account various circumstances, including the common limitation to 50 percent of net before depletion for all minerals. To cut the rate on gross revenue for petroleum would result in lower effective depletion relative to net before depletion than realized on many other mineral operations. The present depletion structure treats all minerals alike in setting a common limit to 50 percent of net, which is controlling on a great deal of the mineral production.

THE PROPER RATE FOR PERCENTAGE DEPLETION ON PETROLEUM

Many changes have occurred since 1926, and it is appropriate to inquire whether the percentage depletion rate set for petroleum then is still appropriate now. One line of reasoning suggests that a cut in the rate is warranted because of the rise in income tax rates since 1926. This approach raises the fundamental question whether percentage depletion is a valid principle to be applied consistently regardless of changes up or down in the tax rates, or whether it should be considered as an incentive to be kept roughly constant by changes inversely related to the rise and fall of tax rates. The continuity of treatment provided by Congress through discovery value (set in 1918 when tax rates were high) and its equivalent of percentage depletion (set in 1926 when a lower level of rates prevailed) appears to reflect an intent to protect from taxation as ordinary income the capital value needed to continue in business. The need for consistent application of this principle really becomes more important when tax rates are high, because such rates create the greatest threat to maintenance and expansion of the capital investments required to achieve prosperity for an expanding population. Many other differential tax provisions, such as the treatment of capital gains, have been kept constant by Congress through many fluctuations in rates up and down. It should be noted that fluctuations in rates of percentage depletion would create another uncertainty in appraisal of new investments in mineral production, on top of the inescapable uncertainties in this business which already cause investors to demand a premium for risk.

The rise in tax rates since 1926 is only one of many changes that needs to be taken into account in appraising whether the same rate of percentage depletion is still appropriate. Oil and gas are now much more vital to our progress and security than they were in 1926. They now supply about 75 percent of our energy needs, compared with only 25 percent back in 1926. Consumption has multiplied fivefold for oil and tenfold for gas in the past 37 years, and the capital requirements have increased much more as the search has had to be extended to deeper horizons and to less accessible and more expensive locations, such as the offshore Continental Shelf of the gulf coast and west coast. Because of the principle of diminishing returns characteristic of resource industries, the risks in exploration are greater now than in 1926. Despite great technological progress and large expenditures on geology and geophysics, the proportion of dry holes has increased from 27 percent of the total wells drilled in 1926 up to 38 percent in recent years. Under the tax rules that have been in effect, millions of investors have risked many billions of dollars in creating a large industry that has contributed immeasurably to the growth and development of our Nation. All of these circumstances, as well as the current level of tax rates and the general changes now being considered, must be taken into account in appraising the proper rate of percentage depletion.

Two approaches can be used to evaluate the existing rate of depletion for petroleum. The first is to ascertain whether the present rates still measure the discovery value of new properties, since that is the value depleted by production and that is the basis on which a purchaser would be allowed to compute depletion. In recent years, a large number of sizable sales of producing properties have been made at average prices that appear to range upward from 93 cents per barrel of proved reserves in the ground. Average realizations on proved reserves appear to be in the range of 32 to 42 percent of the current average selling price of $2.88 per barrel for crude oil as produced at wells. Even excluding development costs from the total consideration, the prices paid for oil in the ground appear to exceed the average realized through percentage depletion.

A second approach to the reasonableness of existing rates takes into account the opportunity that developers of reserves have to realize on their success through the capital gains route. Unless continued operation of a property is about as attractive as outright sale, many operators will be tempted to sell out and retire from the business in order to enjoy past success without the need of continuing exposure to a high level of risk taking. The increasing sales of producing properties in recent years indicate that already, even with existing rates of percentage depletion, liquidation is becoming more attractive than continued operation. Since 1960, producing properties with a value well in excess of $3 billion have been sold, including a number of trades in which the consideration exceeded $200 million.

The operator who sells out pays a capital gains tax but then has the remainder as capital available for alternative investments, including many less hazardous in nature. The price paid generally causes deductions based on cost to exceed the

maximum under percentage depletion, so that the appraisal of value is not based on what percentage depletion is worth to the seller. Sales of producing properties absorb capital that would otherwise be spent in the search for new supplies and also tend to reduce the number of operators engaged in exploration and drilling. Both of these developments are undesirable from the standpoint of keeping successful discoverers in the business and of attracting sufficient capital into the search for new supplies adequate to meet increasing demands. Any reduction in the rate of percentage depletion would swing the balance more heavily in favor of sales of reserves in the ground.

Another criticism of the rate for percentage depletion is based on the proposition that too much capital has been attracted into petroleum production. If this were so, then an immediate reduction in investment might be considered a favorable development, which could be corrected later if the lower rate of investment proved inadequate for the long run. Superficially, the evidence seems to support such a proposition, but the conclusion is subject to question when all the facts are considered. The restriction of prorated wells in Texas to 28 percent of their allowable should not be misinterpreted as an indication of the degree of overinvestment or the amount of shut-in capacity. Such restrictions apply only to prorated wells, and the majority of wells in Texas and elsewhere in the United States are producing all they can because they are exempt from controls based on market demand. For the United States as a whole, current shut-in capacity is equivalent to about 30 percent of the maximum capacity to produce crude oil and natural gas liquids. Much of this capacity might be needed in an emergency if requirements increased by only 10 percent and if oversea imports of crude oil and unfinished oils were interrupted or had to be diverted to meet European demands. Even at existing levels of production, proved reserves are being drawn upon at the rate of 8 percent a year for crude oil and 5 percent a year for natural gas. In recent years, new reserves have been developed in amounts only slightly greater than production, with the result that proved reserves have not increased as rapidly as domestic demands. The main reason why shut-in capacity appears large relatively to current requirements is that technological developments of recent years have hastened the rate at which reserves can be produced efficiently. To rely on this change as a basis for slowing down development of new resources would merely speed up the rate at which we deplete known reserves and emphasize the need for additional exploration and drilling to keep pace with rising future demands.

The basic test of whether there has been too much investment in petroleum lies in our reserve position rather than in the estimates of productive capacity. From this point of view, our situation is comfortable, but not any stronger than it should be. Proved reserves of oil are only about 12 times the current annual rate of production, roughly the same relation that has prevailed over the past 25 years, during which there have been times when we were worried that supplies might not keep pace with demand. Proved reserves of gas are only 20 times current annual production, much lower than in earlier years and at about the minimum level desirable for economic operations. These circumstances indicate that the petroluem industry has not been spending too much on searching for new reserves. On the contrary, it appears that the rate of discovery and development of domestic petroleum resources must be stepped up in the years ahead to keep pace with the needs of the Nation. Such action will require an increase rather than a decrease in the amount of funds being spent on the search for new reserves.

In the next 20 years the United States will need to produce substantially more oil and gas than the present estimates of proved reserves. The recent level of expenditures for exploration and development has been sufficient to bring forth new reserves at a rate of about 3 billion barrels of petroleum liquids and 18 trillion cubic feet of gas, or only slightly ahead of current levels of production. The need for increasing quantities of petroleum in the United States is not far ahead. Because of the long timelag between initiation of a higher level or effort and the realization of substantial production, the recent downward trend will have to be reversed fairly soon in order for the United States to have adequate supplies and reserves in the years ahead. Since the present level of economic incentive to invest in this business does not seem higher than needed in terms of the effort required for the long run, it would seem unsound to reduce such incentives by a cut in the rate of percentage depletion.

In recent years, investments in pertoleum exploration and drilling have declined while investments in other sectors of the economy have increased. This

trend indicates that the relative attraction for investors to risk funds in petroleum has decreased even with the existing rate of percentage depletion. A cut in the rate now would not only have an immediate financial effect but also a psychological impact working to discourage new investments. In view of circumstances indicating that more investment in petroleum will be needed soon, the long-established percentage depletion rate for petroleum production continues to be necessary as well as no more than appropriate to existing conditions.

GRADUATED DEPLETION

Another proposal for collecting more taxes from petroleum production would graduate percentage depletion on the basis of the amount of income. The specific measure considered by the Senate last year would reduce the rate of depletion on gross revenue to 15 percent if gross income exceeds $5 million a year. Several years ago the Treasury Department estimated that the effect of such a proposal would be to raise taxes by 95 percent as much as if the rate were reduced on all production. The proposal is subject to two objections: (1) It would have practically the same impact as a general reduction, and (2) it would introduce an element of discrimination based on size.

Both small operators and large companies play an essential role in the search for and development of new reserves. The relative role of small and large firms cannot be measured by statistics on the number of exploratory wells drilled or on the number of discoveries because of differences in the nature of the wells drilled and of the interrelation of the activities of different size firms in drilling a test. Frequently, both large and small companies own acreage on the same prospect, and large companies often contribute to the cost of a wildcat test to be drilled by a small operator because that may be cheaper than drilling a well directly. The records may show a discovery by a small operator in such case, but a substantial part of the cost may have been provided by major companies. Furthermore, small operators generally drill the cheaper, shallower wells, while large companies drill the deeper and more expensive exploratory wells. Firms producing large quantities of oil must risk many millions of dollars in an effort to offset the decline in reserves due to production. On these operations, the large firms unquestionably suffer substantial losses on many unsuccessful ventures. The results of risk taking are more erratic for even the largest firms than they are for the industry as a whole. Losses on exploration may not be readily apparent to outsiders because they may offset only part of the profits from production, but each firm must weigh carefully whether it would be better off to cut back on exploration if the rewards from new expenditures are not commensurate with the risks.

The risks of the search for oil cannot be escaped merely because a company drills a large number of wells. The probability of success or failure on each venture remains the same whether the firm is drilling one well or a hundred. The large firm can stand more failures without being forced into bankruptcy than a small one, but it may still be worse off than if it cut back sharply on the expensive ventures needed to test new areas in order for the industry to continue developing additional resources. Without this type of pioneering, the opportunities for the smaller operators will be reduced, and the future of our domestic supplies would be much less favorable.

The cost of the search for oil has become so expensive in some new areas, such as the offshore areas of the Continental Shelf and Alaska, that even the largest firms in the industry often consider it prudent to undertake such operations by means of joint ventures in order to avoid too drastic an impact on the financial results of 1 year of a single failure that may cost $10 million or more. In these circumstances, large companies need as much incentive to continue an aggressive search for oil and gas as do small ones. Therefore, we should not discourage either group by discrimination in the rate of percentage depletion.

CHANGES IN AGGREGATION PROVISIONS

The tax bill passed by the House of Representatives would require that aggregations authorized by the Revenue Act of 1954 be discontinued after 1963 and would not allow aggregations for petroleum in the future. Other mineral industries would continue to be allowed to aggregate properties within an operating unit, while petroleum companies would be limited to use of the aggregation principle for the years 1954 through 1963.

Aggregation was a step in the direction of allowing the combination of numerous properties within an operating unit in computing depletion. The Treasury Department considered some of the operating units chosen by taxpayers to be inappropriate and recommended that this provision be denied to petroleum producers. The issues involved in determining appropriate units must be settled in any case for the years 1954 through 1963, as has already been done by most taxpayers. Aggregations are binding for the future once they are made, so that no serious administrative problems would be involved in continuing in effect the aggregations that will be recognized as appropriate under the 1954 law.

The proposed change will present problems for many taxpayers, particularly in allocating remaining leasehold cost among individual properties included in aggregations. This action would also treat operators engaged in petroleum production differently from those in other mineral industries which will still be allowed to aggregate properties. Finally, the added tax payments will make development of some oil and gas properties less attractive. The Treasury Department estimates that the amount of additional taxes involved is $40 million, which is equivalent to about 2 percent of the annual expenditures for drilling of new wells. If the change becomes effective, it will probably depress the level of drilling at least by 2 percent and perhaps considerably more. Since drilling has declined substantially in recent years, and has been inadequate to increase proved reserves of oil and gas in keeping with demand, a further decrease in drilling would be a move in the wrong direction. Therefore, the associations that I represent recommend that aggregation of properties within operating units be continued in effect for all mineral industries, including petroleum.

TAX PAYMENTS OF THE PETROLEUM INDUSTRY

Since some proposals to increase taxes on petroleum appear to be based on the premise that the tax burden of this industry is much lighter than that of others, it is informative to examine tax revenues generated by petroleum operations.

Minerals are taxed differently from other industries by State and local governments as well as by the Federal Government. In Texas and Louisiana, which account for about two-thirds of the petroleum produced in the United States, severance taxes range from about 5 to 10 percent on value. Severance and property taxes of all States average about 21 cents per barrel and represent approximately 7 percent of gross revenue from oil and gas production.

State and Federal gasoline taxes, which now average more than 10 cents a gallon, yield revenues in excess of $6 billion annually, equivalent to 75 percent of the gross value of crude oil produced in the United States. Not all of this burden can be justified on the benefit theory, since some States divert part of these revenues to nonhighway purposes and since part of the cost of highways should be financed from general revenues because of the benefits they provide for defense and for the general public. Thus, the combined effect of special burdens on domestic petroleum operations caused by severance and gasoline taxes together is quite large in relation to the value of crude oil production.

The petroleum industry also pays other property and excise taxes as well as State and Federal income taxes, franchise taxes, and many other taxes applicable generally to business. Statistics are not available on tax payments of the producing operations of the domestic petroleum industry alone, but a study has been made comparing the total taxpayments of the petroleum industry with those of other industries by the Petroleum Industry Research Foundation, Inc., of New York. This study examined the taxes paid in the United States by 25 large oil companies with operations primarily in this country and by manufacturing and mining corporations generally, exclusive of the beverage and tobacco industries. The petroleum companies paid excise and sales taxes averaging $2.4 billion annually and other taxes averaging $657 million. Excise taxes were 17 percent of gross revenue for these companies and other taxes were 5 percent of gross revenue. For manufacturing corporations, taxpayments in the 3-year period 1959–61 averaged 5.1 percent of gross revenue. These figures show that the proportion that total taxes represent of gross revenues is about the same for petroleum as for manufacturing generally if excise and sales taxes are excluded, and much higher including any significant part of the excise taxes.

The 25 companies included in the study of the Petroleum Industry Research Foundation account for only part of the taxpayments of the industry. For example, the excise taxpayments by these companies are only 40 percent of total gasoline tax revenues. If their other taxpayments represent the same propor-

tion of the total for this industry, then the tax revenues realized on petroleum operations in the United States amount to about $8 billion a year. Such payments represent a sizable contribution to the total taxes collected from business by all forms of government.

The question may still be raised whether the income tax burden of the petroleum industry is not much lighter than that of other industries. The answer to this question depends on the definition of income, particularly whether income is defined to include capital values that must be retained in the business in order to avoid reduction of basic assets. Percentage depletion can exclude from taxation no more than 50 percent of net income before depletion, so that it leaves substantial revenues subject to income tax. The examples sometimes cited of firms with sizable income, but with little or no income taxpayments must reflect the effect of heavy current deductions for tax purposes of intangible development costs that are being capitalized in financial statements, but will have to be charged off in later years. Such cases represent situations in which a major part of the funds of the firms, and often substantial sums of borrowed money as well, are being plowed back into a program of expansion which will generate substantial tax liabilities in future years. In these circumstances, the tax provisions are accomplishing their intended purpose of encouraging the investment of funds in exploration and development which will provide additional supplies of energy for the economy.

Any consideration of tax revenues generated by petroleum operations should also take into account the favorable influence of oil and gas supplies on general economic progress. In stimulating the growth of our economy, petroleum has also contributed to a general expansion of national income and to the revenue generated by the tax system. Only a modest gain in the general rate of economic growth as a result of the provisions that have encouraged investment in petroleum production could mean far more tax revenue than the amount which might be realized temporarily by heavier taxes on petroleum production.

EFFICIENCY OF THE DIFFERENTIAL TAX PROVISIONS FOR PETROLEUM

Some critics contend that the existing tax differentials are inefficient in promoting public welfare. One criticism is that they result in a misallocation of resources because they attract more capital into the industry than would be the case in their absence. It has already been noted that a risky and capital intensive industry, such as petroleum production, would be at a disadvantage in attracting capital, but for differential tax treatment, and that failure to provide appropriate differentials would result in misallocation due to underinvestment in petroleum. A positive incentive to encourage relatively greater investment in petroleum than would exist in the absence of income taxes may well serve the Nation effectively because of the favorable impact of oil and gas on economic growth and national security, in the same manner that the investment credit is expected to benefit the economy despite its immediate costs in tax revenues.

The question is also raised whether depletion merely hastens the exhaustion of domestic resources and therefore runs counter to national security. This view assumes incorrectly that undiscovered resources enhance national security. In fact, however, only discovered and developed resources are useful in emergencies. Percentage depletion encourages more exploration and greater discovery of resources that may otherwise remain unknown forever. Studies by various agencies indicate that the United States has ample prospective energy resources remaining to be discovered and developed, so that it is not faced with running short of liquid fuels for emergencies so long as it encourages continued development.

The system chosen by Congress to recognize capital values and encourage investment bases rewards on efficient contributions to development and production of mineral resources. The limitation of depletion to 50 percent of net income before depletion acts as a powerful incentive for the operator to recover as much oil as economically feasible and to be efficient in controlling costs. For royalty owners, percentage depletion is a clear recognition of capital values involved in depletion of a wasting asset. To deny such treatment to royalty owners would only force them to turn to outright sales of their interests as a means of achieving adequate compensation for the separation of irreplaceable assets from their property.

Suggestions are sometimes made that a better and cheaper system might be devised to achieve the rate of development of petroleum resources consistent with public needs. Among the alternatives mentioned have been direct

subsidies, stockpiling, and premium prices for additional production. Examination of each alternative suggested reveals problems and the likelihood that the changes could be more expensive and less effective than the present system. In 1952, the President's Materials Policy Commission reached the following conclusion, which is still sound today, concerning the idea of satisfactory alternates to the present system:

"In short, the device of percentage depletion as an incentive to minerals exploration is not without its limitations. But no alternative method of taxation has come to the Commission's attention or could be devised by the Commission which, in its judgment, promises to overcome these limitations and still achieve the desired results, particularly not without seriously dislocating well established capital values and other arrangements in the industries concerned, with highly adverse effects on supply. Taking the practical situation as it finds it, the Commission believes thta any radical alteration of the existing tax arrangement would be undesirable."[4]

CONSEQUENCES OF A CUT IN PERCENTAGE DEPLETION

A reduction in percentage depletion would have both short-term and long-run effects of a magnitude depending upon the amount of additional tax burden. The immediate impact would be on thousands of operators and on millions of owners of stocks in oil companies who have risked vast sums of equity capital and of borrowed money in exploration and drilling with the expectation that percentage depletion would remain in effect for the life of their successful ventures. These rates have become part of the economic structure of the industry, working to the benefit of consumers and the Nation through their influence on ample supplies of oil and gas at reasonable prices. A cut in the rates now would be a change in the basic principles of taxation that would reduce incentives to invest new funds. The consequence over a period of time would be the development of smaller amounts of new reserves, decreased availability of domestic supplies, and relatively higher prices.

The impact of a cut in depletion might be lessened if petroleum production were currently highly profitable or if the margin between rates of return in this industry were rising relative to others. The evidence does not indicate this to be the case. On the contrary, during the past 15 years the petroleum industry has experienced a sharp decline in its rate of return. Recent changes in tax treatment have worked to make investments in other industries more attractive, while the proposals for petroleum would make it less attractive. Therefore, it should be expected that imposition of additional income taxes on oil and gas production will cause a further decline in expenditures for exploration and drilling beyond the substantial decrease that has already occurred since 1956.

A further decline in drilling would affect drilling contractors, employment, the steel and equipment industries, and may small businesses engaged in servicing the producing operations of the petroleum industry. Such developments would run counter to the general objective of attaining a healthy rate of general economic growth.

Over the long run, smaller domestic supplies of petroleum would weaken national security and bring about higher prices for petroleum products. The repercussion of these developments could be widespread. If smaller investments in petroleum were offset by additional outlays in other sectors of the economy, there would be some offsetting benefits, but the net effect on tax revenues could still be negative because of the high taxes per dollar of sales on petroleum operations.

It seems to me that a cut in percentage depletion would result in some definite short-term disadvantages which might become intensified with time instead of disappearing. I believe that the best course is to stay with the long-established differential tax provisions that have served the Nation well over a period of about 50 years.

CONCLUSION

Taxation of mineral production is an extremely complex matter. It is also highly important because minerals are the raw materials essential for rising standards of living in an industrial civilization. Some discussions of percentage depletion look only at income tax revenues without adequate consideration of

[4] The President's Materials Policy Commission, "Resources for Freedom, Foundations for Growth and Security," June 1952, vol. 1, p. 35.

the relation of this provision to the development of new resources needed to support a healthy rate of growth for the entire economy.

The differential income tax provisions for petroleum were not arrived at arbitrarily. Instead, they were based on studies of the industry which indicated a number of reasons why the differentials adopted were desirable. Over a period of years, these provisions have become part of the economic structure of the petroleum industry, and billions of dollars have been risked by investors in the belief that they could count on continuance of this treatment over the life of their investments. A change in rates would undermine confidence as to the continuity of tax treatment for the future, adding an unnecessary uncertainty to the inescapable risks inherent in the very nature of the search for oil and gas.

The rates of percentage depletion that have been in effect for petroleum since 1926 continue to be warranted by conditions that exist now. They cannot be reduced without risk of repercussions that will hamper economic progress and weaken national security.

The CHAIRMAN. Thank you very much, sir.

Mr. Wallace W. Wilson, you may proceed, sir.

STATEMENT OF WALLACE W. WILSON, VICE PRESIDENT, OIL DIVISION OF CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO. OF CHICAGO

Mr. WILSON. Mr. Chairman, my name is Wallace W. Wilson. I am vice president in the Oil Division of Continental Illinois National Bank & Trust Co. of Chicago.

A banker must have a working knowledge of the business in which his customers are engaged as well as detailed information on the activities of his customers. These are especially important in oil and gas financing because of the risks peculiar to the business and the vast amount of capital which is obtained by borrowing. A recent survey indicates that commercial bank loans, secured principally by oil and gas production, now are in excess of $2½ billion.

Oil and gas loans are notably different from conventional bank financing. In nearly all instances borrowers secure such loans with deeds of trust to producing oil and gas properties, along with direct assignments of the proceeds of production from the pipelines which purchase the oil and gas; furthermore, such loans nearly always run for periods of 3 to 7 or more years.

Obviously the amount which can be loaned must be less than the indicated market value of the properties taken as security, to provide for recoupment in the event of foreclosure, out of net proceeds after any capital gains taxes.

Exploratory ventures and most development drilling programs cannot be directly financed by bank loans. The risks involved in operations of this type are too great to permit banks to rely for their principal security on prospective reserves which may or may not be present. An oil and gas producer who borrows money for drilling ventures must collateralize the loan with other assets, often all or a substantial part of his developed and producing preporties. Thus he faces a double hazard: In addition to risking the capital in the new venture he also risks the loss of the assets which secure the loan. In the event of substantial failure he may be wiped out.

Why does he do this? First, because he has confidence in his ability to evaluate both the risks involved and the prospective rewards. This is essentially the way that every oil company, large and small alike, has been able to achieve growth. And secondly, because the existing tax

provisions are based on incentive. Percentage depletion is effective as a deduction in computing taxes only when a property is operating profitably. The option to deduct intangible drilling expenses has no significance if there is no income. One cannot simply spend his money on unrewarding projects in the oil and gas business and derive any permanent benefit from either provision; the ultimate result inevitably is failure and loss of invested capital.

A banker who works with oil and gas producers is continuously aware of the risks which his customers must assume, even if they are to do no more than maintain their competitive position in the industry. One cannot take lightly the responsibility for arranging financing which will require repayment out of a substantial percentage of gross income over a period of many years, when the proceeds of the loan are to be used for ventures which may not be profitable. The alternatives, however, are either gradual or immediate liquidation, neither of which contribute to the economic welfare of the Nation.

You have heard many times of the huge capital expenditures which have been and must be made to replace reserves of oil and gas which are being produced from developed fields. The funds are realized out of depletion, depreciation and retained earnings, plus net proceeds from new capital and borrowing. New expenditures for replacement of reserves in recent years have exceeded all capital extinguishment provisions, and have required the reinvestment of a substantial part of net income.

Mr. H. A. True, an independent oil producer, made the following statement in testimony presented to the House Ways and Means Committee in March of this year:

> During the entire 12 years I have been an independent oilman, every penny allowed as depletion, plus every dollar which could be borrowed, has gone back into the exploration for the development of oil reserves. In addition, to provide funds for tangible equipment, several of the better properties we have developed have had to be sold.

This is by no means an isolated case. There are thousands of producers, large and small, who operate on the same basis. This is literally the only way that oil and gas producers can achieve growth.

In his testimony before the Ways and Means Committee of the House of Representatives in December 1959, Dr. Richard J. Gonzalez pointed out that oil and gas producers would be tempted to sell out when this course of action is about as favorable as continued operation. He cited the increased number of sales of producing properties as indicating that present depletion rates are close to a breakeven point with outright sales.

In the intervening 4-year period, the so-called sellout trend has become one of the most dominant factors in the domestic petroleum industry. During the last 3 years oil and gas property sales have occurred involving a total consideration in excess of $3 billion. Sales have ranged over the entire gamut from small individual leases to the entire holdings of some of the larger independent companies.

The current volume of sellouts is largely the result of economic factors, most of them being related to conditions which Mr. Decker covered in his testimony. In short, some companies have concluded that a more satisfactory rate of return can be obtained from capital investments in producing property acquisitions than in many available exploration ventures. The selling companies have concluded that

it is more advantageous to liquidate than to continue to operate under present and foreseeable economic conditions.

Historically there always have been a reasonable number of property sales and complete liquidations, resulting from a need to reduce debt, or to raise new capital. The present trend, however, is greatly in excess of normal, and probably will reach a new high in 1963. One significant reason for the increased activity this year is the concern which was created by the four proposals in the President's tax message, affecting the petroleum industry. Many of our customers told us that the adoption of these proposals would cause them to curtail their investments in new ventures, and give consideration to the sale of their present holdings. Several of them promptly concluded arrangements for liquidation, principally for this reason. Under the circumstances this was a logical reaction. The possibility of changes in long-established methods of computing statutory depletion and taxes on capital gain would be a major additional risk factor to continued operation.

The bank with which I am associated has arranged or participated in the financing of a large number of producing property transactions. Our analysis of this activity indicates that selling prices of producing properties equate to about $1 to $1.30 per barrel of reserves, averaging about $1.20. In some cases, this includes a substantial percentage of undeveloped reserves which involve an added element of risk and which will require additional capital investment in the future. The average realization of $1.20 per barrel is about 42 percent of the average market price for crude oil. Statutory depletion at the rate of 27½ percent of gross income, or at a somewhat lesser effective rate because of the 50 percent of net income limitation, is a very conservative measure of the capital value of reserves in the ground.

One might ask why, in the light of this analysis, even more producers have not liquidated their holdings. The principal reason is that elements of risk and opportunity affect each operator differently. So long as reasonable opportunities for growth remain, many would not contemplate the sale of their holdings. But any substantial diminution of opportunity, such as changes in the tax laws affecting the petroleum industry, without a doubt would precipitate sellouts on a larger scale. This inevitably would change the makeup of the domestic industry and divert large amounts of capital from necessary exploration and development activities to the acquisition of developed reserves.

If, as I firmly believe, it is in the national interest to maintain a strong and effective domestic petroleum industry, then it follows that tax policies which would discourage investment for further growth should be avoided.

The effects of changes in tax policy on equity capital also need to be considered. The petroleum industry has wide diversity of ownership in spite of its generally conservative dividend policy. Adverse changes in the tax laws, which would inhibit growth or decrease earnings, would result in lower equity values and extensive capital losses. The security of bondholders and lending institutions would be jeopardized, leading to increased difficulty in raising capital funds by borrowing. The net effect of such a major shakeout of equity values cannot be predicted, but likely would largely offset any immediate increase in direct tax revenues from the petroleum industry.

The present system of taxing proceeds from oil and gas production has worked, because it is based on incentive. It permits the successful operator reasonable opportunity to retain part of the capital needed to find and develop new sources of supply, but it does not reward the inefficient operator. It has encouraged sufficient growth in reserves and producing capacity to meet the needs of an expanding economy, with spare capacity for emergency needs. It has been reviewed repeatedly and exhaustively by the Congress and by governmental commissions, and always has been confirmed without change. I submit that this tax policy has met the test of time, and should be continued unchanged.

I thank you.

The CHAIRMAN. Thank you very much. Any questions?

Senator DOUGLAS. Mr. Chairman, may I ask a question?

The CHAIRMAN. Yes.

Senator DOUGLAS. I would like to address a question with perhaps particular reference to Mr. Gonzalez and if Mr. Decker or Mr. Wilson also wish to reply I would welcome that. Of course, it is true that depletion allowance is only one of several tax provisions which apply to the oil and gas industry.

First, is it not true that the cost of drilling the dry holes can be charged off against the income from the successful drillings?

Mr. GONZALEZ. Dry holes are a loss and like any other loss in business are deductible at the time——

Senator DOUGLAS. Was my statement correct then, that the cost of drilling dry holes could be charged off against the income from the successful drillings?

Mr. GONZALEZ. Yes, the cost of drilling dry holes can be charged off against them.

Senator DOUGLAS. May I not ask this to follow up the previous question:

Cannot the major proportion of the drilling and developmental costs be written off in the first year of production?

Mr. GONZALEZ. The law provides that intangible development costs can be written off at the time that they are incurred. The tangible development costs all have to be capitalized and recovered through depreciation.

Senator DOUGLAS. But is it not true that about 75 to 80 percent of drilling and developmental costs are written off in the first year of production?

Mr. GONZALEZ. I don't know what the percentage would be, Senator Douglas. The development costs are not charged off at the time they are incurred. The intangible costs are.

Senator DOUGLAS. Yes.

Are you acquainted with the material submitted by the Secretary of the Treasury dealing not only with depletion which I have already quoted but also on exploration, development, and acquisition costs, which are contained——

Mr. GONZALEZ. I do not have the figures before me.

Senator DOUGLAS. I would like to refer you to that material beginning on page 319 of the House hearings. I have the material here before me; namely, that of the exploration expenditures totaling $1,214 million, there was deducted as a current expense, in the first

year, $922 million. This was well over three-quarters of the developmental expenses. Of the $2,070 million that was deducted in the first year, as a current expense, $1,308 million, or approximately two-thirds, was written off for all mineral products, but for oil and gas the ratios are approximately the same but somewhat higher in the case of exploration expenses.

Now, do you know of any industry in the country where the depreciation rate is as high as that?

Mr. GONZALEZ. The mining industries generally, Senator Douglas, are allowed to write off their development expenses as they occur.

Senator DOUGLAS. Here you have, I think, 75 percent of the prior expenses written off in the first year. Do you know of any industry of the country that has as high a depreciation rate as this?

Mr. GONZALEZ. Senator, I am saying that these things—this treatment applies to the mineral industries generally, and the mineral industries are in a separate category from manufacturing industries.

Senator DOUGLAS. It raises a real question of whether the mineral industries should be given so much greater advantage in taxation policy than manufacturers. I don't question the cost of deduction of the dry holes, and I am not making war as of this moment on the drilling and developmental costs being charged off in the first year.

But in addition to all this, then you get exemption from taxation of 27½ percent of the gross revenue, up to 50 percent of net income, and this is a tremendous advantage. Shouldn't you give up a little?

Mr. GONZALEZ. Senator, this is a matter for congressional judgment, and Congress has frequently reviewed this in the past, and it is a question of whether these provisions serve the public interest. Now, the record is pretty clear, we think, that oil and gas are very important to the economy of this Nation, and that they have served this Nation well. In fact, they have literally brought us from the horse-and-buggy days to the jet age. They have had a tremendous impact.

Senator DOUGLAS. There have been great technical advances beyond question; there is no doubt about that. But does this justify the tremendous tax favors which are accorded to you people?

Mr. GONZALEZ. These——

Senator DOUGLAS. Everyone can preen themselves on their contributions to society as producers. But isn't there some obligation which is owed to support the common institutions of the United States; namely, the cost of national defense, the cost of atomic energy, the cost of space (which frankly is a little bit heavier than I would like), interest on the national debt, pensions and hospital care of the soldiers, modest payments for old-age assistance, and for health and education?

I mean isn't there some obligation to meet these costs?

Mr. GONZALEZ. Senator, the benefits of these provisions have been passed on to the public, and this is reflected by the prices of the products and by the rate of return in the industry.

Now, if we want to change these provisions, and collect more taxes from this, then we must expect that we will have to pay higher prices.

Senator DOUGLAS. Now, Mr. Gonzalez, you have touched on a very significant point. You said the rate return of the industry is not above that of other industries and so far as I can tell this is approximately true; namely, in spite of the tax favor, your average rate of return is only what the other industries are getting.

Now, the reason for this is that the tax favors have encouraged capital to go into the industry which would not have gone there in the absence of the tax favors. It therefore has led to investment beyond the point of what we can call social marginal return.

Mr. GONZALEZ. Senator, I think the figures show that the American public wants to use a lot of oil and gas—uses it very effectively in order to promote economic progress. The machinery that we use which makes it possible for us to work shorter hours and yet enjoy better standards of living is operated with inanimate energy.

The mineral industries are the basis of an industrial civilization.

Senator DOUGLAS. I have said that the average rate of return is probably no greater than that in other industries but in individual instances the tax favor leads to very great returns and provides the possibility of riches beyond the dreams of avarice as Dr. Johnson once remarked of the Thrale, the brewer.

We have records of companies which have made large profits over periods of time and paid almost no taxes, none at all, or 1 percent or 2 percent, or 5 percent.

I remember an individual case of a man who over a period of 5 years had earnings of $13 million net and who paid only $80,000 in taxes during this time, two-thirds of 1 percent. The poor fellow getting $100 a week, $5,200 a year, with a wife and two children, was paying around $400 or around 8 percent.

Now, very frankly, these gross injustices, if they were to be known, would affront the public spirit of the citizens of this country. It is very hard to get them known and it is very hard to get corrective action in the Congress.

You are a very powerful industry, and yet these are the facts.

Mr. GONZALEZ. Senator, I think if you would examine what happened on the part of those individuals or companies that you mentioned, you would find that those companies are engaged in putting money back into exploration and development of new resources, and, presumably, this is why the tax provisions were authorized.

Senator DOUGLAS. That is purely voluntary on their part if they do so.

Mr. GONZALEZ. Well, the fact that they do not pay taxes, according to the figures that you have cited, suggest that they must have been putting their money back into this business.

Senator DOUGLAS. What I am trying to say is that in addition to the depletion allowance, there are these other tax provisions, notably the the writing off of drilling—exploration, drilling and developmental costs—largely in the first year.

I am not proposing to alter the question of the speedy writeoff of a nearly 100-percent depreciation rate for exploration, drilling, and development, but you have got all this and heaven, too. You have got all this and the 27½-percent depletion allowance, and I am not even proposing to take that away from you. I am saying that the big companies could retain 15 percent, that the little operators with less than a million could keep the full 27½ percent, and these small firms, the independent producers, those between 1 and 5 million, would get 21 percent.

I have been proposing this for 10 years and getting no response from the small producers. I would expect the big producers, such as

Humble, which I believe is a subsidiary of Standard Oil, I would really expect them to oppose this.

But I am disturbed about the small producers. I think that is enough for me to say.

The CHAIRMAN. Thank you, gentlemen.

Senator DOUGLAS. I imagine you will be victorious this year as you have been in the past.

Mr. GONZALEZ. We trust. [Laughter.]

The CHAIRMAN. The next witness is Mr. Stanley C. Woods, Texas Landowners & Independent Oil & Gas Producers Association.

Mr. Woods, take a seat, sir, and proceed.

STATEMENT OF STANLEY C. WOODS, PRESIDENT, TEXAS LANDOWNERS & INDEPENDENT OIL & GAS PRODUCERS ASSOCIATION

Mr. WOODS. Mr. Chairman and members of the committee, I am Stanley Woods, of Houston, Tex., an attorney and independent oil and gas operator.

The Texas Landowners & Independent Oil & Gas Producers Association, of which I am president, has specifically authorized my coming before this honorable committee today. I speak officially for that association, as well as on my own behalf.

Because the objective effect of the decisions to be reached by this committee will not only bear upon the Nation's tax structure but also will inevitably affect the lot of many types of enterprise, I appreciate this opportunity of calling your attention to the little understood condition of the petroleum industry, on the future of which your findings may bear heavily.

Many heretofore productive communities in Texas and elsewhere are in chronic crisis. Production, payrolls, and prosperity have fled. This is not because their underlying natural resource has become exhausted. It is because of interstate and international factors which have combined to wreak havoc in our industry. It is to these that I would draw your attention.

Only 3 days ago a respected national publication, Business Week, revealed that a major oil company is moving its corporate headquarters from Houston to New York City. The firm's president said that "you can't run a major international oil company effectively from Houston."

The same article reports that this integrated company will next week, for the first time, pump more crude oil out of Libya, Canada, Venezuela, and Iran than it produces in the United States.

The corporate practice mentioned is not extraordinary; it is increasingly typical of major oil companies seeking cheap crude and preferring to refine and market only their own production.

Whether this is in the public interest is debatable. But the fact that this Nation can only depend upon foreign oil when it doesn't need it is not debatable. One has only to recall the Suez crisis to be reminded that, when international tension is critical, this country finds itself dependent in large measure on its own petroleum production.

And our domestic petroleum does not gush forth in quantity merely by turning a value. It depends upon day-in-and-day-out exploration and drilling where the incentives are woefully lacking at present.

To another facet of the present situation may I respectfully call your attention.

It has been observed that foreign oil lubricates the route for the flight of gold from this country. In addition, the objective effect of nonstop importation of foreign crude is to perpetuate a type of economic colonialism in many lands from which it is secured. This frustrates the efforts of our Government to make such countries economically self-sufficient.

Keeping these lands out of the orbit of potentially inimical interests may be the short-term interest of our foreign policy. But our long-term interests certainly require that these countries develop economies in which they will find utilization, on their own terms, for their own natural resources.

Presently, because of the import flood, Texas production is only shortly more than one-fourth its capacity—this, in a State which has more than 40 percent of the national petroleum reserves.

Now, if anyone should seriously contend that this country will never need its domestic reserves, then a case could be made for abandoning the oil industry—like the pony express—to the American history books.

But such is not the case. We are assured from every quarter that the United States needs those reserves—but not yet. In the meantime, our rig count is down more than 60 percent in Texas; oil towns are becoming ghost towns; skilled geologists are trying to sell groceries to oilfield roughnecks who can't afford to buy them.

Permit me at this juncture to explain that we have no intention of dumping this problem in the lap of the Federal Government. The association which I have the honor to represent yields to none in its insistence that our problems must be solved locally and in interstate forums.

The matter to which we would call your attention is the necessity of retention of the 27½ percent domestic depletion allowance on domestic crude. Our sick industry, without it, would be dead.

For we are dealing with a wasting resource; oil is not a crop to be reharvested annually. The only way that any investment can be made in our industry is for the investor to receive the special consideration to which he is entitled by virtue of the self-depleting nature of this kind of enterprise.

It is respectfully suggested that, if—and I say if, gentlemen—in the wisdom of this committee, any attempt is made to qualify or abrogate the depletion allowance that such cutback would obtain only insofar as foreign oil is concerned.

What is simple justice to the American investor in domestic oil enterprise might turn out, upon closer investigation, to be an unwarranted tax benefit to the oversea investor, or the American investor in foreign crude.

Let it be understood that our association is well aware of the necessarily delicate intricacies of foreign policy. We are aware that the acceptance or rejection of natural resources from many neutral nations plays a major role in cold war strategy. We do not presume to question at this juncture the wisdom of the decisions which placed discretion over the oil imports program in the executive branch of the Government.

But we are, at the same time, in agreement that the granting or withholding of tax benefits in connection with this, or any other enterprise, belongs uniquely within congressional purview, and is a most legitimate concern of this committee.

It is for this opportunity of addressing you on this matter that I wish to express my appreciation and that of my association, and our willingness to be of any possible service to you on these concerns, either now or in the future. I thank you.

The CHAIRMAN. Thank you very much, Mr. Woods; any questions?

Mr. WOODS. Thank you.

Senator DOUGLAS. Let me return to the battle, if I may. You make a very interesting suggestion near the bottom in the next-to-the-last page. You say:

> * * * if, in the wisdom of this committee, any attempt is made to qualify or abrogate the depletion allowance, that such cutback would obtain only insofar as foreign oil is concerned.

Do you know who owns the properties in Venezuela which produce the oil which is shipped into this country?

Mr. WOODS. Well, I would only positively state there are no independents.

Senator DOUGLAS. It is almost entirely Standard Oil, isn't that true?

Mr. WOODS. It could be Standard, and many of the major oil companies; yes, sir.

Senator DOUGLAS. Is it not true that the Arabian-American Oil Co., popularly known as Aramco, has the major, and possibly exclusive, share of production in Saudi Arabia; is that true?

Mr. WOODS. I couldn't positively state, Senator, on the ownership.

Senator DOUGLAS. Yes.

Mr. WOODS. But I again categorically state there are no Texas independents in Venezuela.

Senator DOUGLAS. I can corroborate that. Saudi Arabia again is almost exclusively a Standard Oil affair. Then, I think, one other major oil company owns a share in Aramco, and the major oil companies also control the production in what used to be known as Persia and is now known as Iran. Is that not true, too? No independents are over there.

Mr. WOODS. If there are any independents, it is only one—I don't recall his name offhand—that is overseas. It is almost strictly through combines, or an aggregate of different companies.

Senator DOUGLAS. In other words, foreign oil is produced by the huge companies?

Mr. WOODS. Profitably, that is correct, and our position is that by my coming here, we are not trying to in any way tell this committee what to do about the tax picture, except we point this out if there are any cuts—it was our own beloved Speaker, Sam Rayburn, who initiated, I believe, the depletion allowance, and it was to encourage the finding of domestic crude, and we don't think that the depletion allowance is something that should be used to the detriment of the domestic industry nor do we think that this country in any way should be lowering its national reserves in case of war, because the only oil we can count on, gentlemen, in case of war, is Canada and the United States, because the submarines are going to knock off all your offshore oil and all the boats coming from Venezuela.

Senator DOUGLAS. Let me ask you this: Would you oppose the removal of the depletion allowance for foreign oil shipped in by American oil companies?

Mr. WOODS. I would not oppose it.

Senator DOUGLAS. Would you favor it?

Mr. WOODS. I would almost advocate it.

Senator DOUGLAS. Good.

Now we are together. Now, the united front of the oil industry is being broken.

Mr. WOODS. The only thing I am advocating is that we come here today, and I was sent here specifically by our association and that is, Senator, there be no tax cut on domestic depletion.

Senator DOUGLAS. I understand. I was led into this line of questioning by this very intriguing point that you make, and I am delighted to know that you not only would not oppose but that you would favor a cut in depletion on foreign oil.

Mr. WOODS. I think you will find no Texas independent who is a true independent independent who would oppose your taking depletion cut on foreign oil.

Senator DOUGLAS. Now, I notice you say not only independent but a true independent.

Mr. WOOD. I am talking about independents of the old wildcatting type. We are not depending on anybody except ourselves.

Senator DOUGLAS. You are not controlled by anybody?

Mr. WOODS. We are not controlled by anybody.

Senator DOUGLAS. Good.

Let me ask you this question: Are you aware of the fact that under the international tax laws that taxes levied by foreign governments are chargeable against taxes—taxes levied by a foreign government on American companies can be charged against the taxes which these American companies would otherwise pay to the American Government?

Mr. WOODS. I understand that.

Senator DOUGLAS. And are you aware of the fact that in the Near East the government there owns the land or retains rights to the subsurface deposits of the land? And that this is true in countries under Roman law such as the Latin American countries, which would include Venezuela?

Mr. WOODS. I think that is correct, Senator.

Senator DOUGLAS. Yes.

Therefore, what happens in these cases is that the amounts paid in royalties to the governments can be and are called taxes and, are therefore deducted from the taxes on their income which would otherwise be paid by these companies to the United States.

Mr. WOODS. I understand that is correct.

Senator DOUGLAS. And, therefore, where there is a 50–50 sharing of net income this means that there is a 50-percent writeoff against taxes; isn't that true—a writeoff of 50 percent of net income against taxes which would otherwise be levied, leaving only a 2-percent residual on the 52 percent corporate tax?

Mr. WOODS. That is approximately right, I believe. I want to qualify any statement I make because I——

Senator DOUGLAS. We are speaking approximately.

Where it is a two-thirds and one-third division, or a 75-percent and a 25-percent, and the pressures are moving the ratio about the 50-50 formula, this more than offsets the corporate income tax which these huge companies would otherwise pay; isn't that true?

Mr. WOODS. Well, I couldn't testify for sure on that, Senator.

Senator DOUGLAS. Well, I mean if the 50-50——

Mr. WOODS. Assuming these things are correct because I came, as I told you, on this domestic.

Senator DOUGLAS. The record shows that the former 50-50 ratio is now moving upward to a figure above that, with the larger share going to the governments of the countries in which the oil development takes place. I think it is 70 percent, if I am not incorrect, in Iran.

Mr. WOODS. We understand international oil—the countries are beginning to step into this and cutting down and that is why I brought this up to the committee. Any day these countries may squeeze our foreign investment capital out, and we will be sitting without a sufficient and adequate domestic reserve; our independents are dying on the vine, and we must keep the independent alive in case we have another war, because I don't need to tell you, Senator, I believe that it was that line that came from the gulf up to New York that gave us that fuel in World War II that gave us the final push in Europe, and we again plead with the committee and the Congress that we hope that the depletion will be left. But I do feel——

Senator DOUGLAS. Why do you say "that line"? "That line" was put through by my friend and political associate, Mr. Harold L. Ickes, over the opposition——

Mr. WOODS. Of the major oil companies.

Senator DOUGLAS (continuing). Of the major oil companies.

Mr. WOODS. That is correct. And I want to be sure I get on the record that the independents are now beginning to awaken to the fact that this country may be short of reserves, and I am not trying to build up a case against the majors, big or small, but the facts are that we may be in a perilous condition and we as an independent industry owe a duty to the U.S. Senate to bring to their attention these facts.

Senator DOUGLAS. I am very appreciative.

Would you favor a further change in the tax laws in that the amounts paid by American oil companies operating abroad ostensibly for taxes should really be charged as a royalty against operating costs so that their net profits after the payment of royalties would then be subject to American taxation? Would you favor that?

Mr. WOODS. You are getting warm, Senator.

Senator DOUGLAS. Well, I thought so. But would you favor that?

Mr. WOODS. I would have to study—I mean, I want to beg off; I am not trying to evade you on this, because I am somewhat at a loss——

Senator DOUGLAS. You are a true independent.

Mr. WOODS. I am a true independent and I am making that point, but I want to say that if you are going to work on anything affecting taxes on us, Senator, there is a fertile field in the foreign picture because the whole thing is we cannot count on foreign oil in case of emergency and, as I see it, the biggest thing we have to come before this committee is that we are furnishing the primary fuel.

Senator DOUGLAS. Would you work with me on some affirmative measures dealing with foreign oil?

Mr. WOODS. I certainly will, Senator, and I will say this—that a great majority of the Texas and Kansas independents—I have talked to them; I have talked to Oklahoma independents across the Nation—they are vitally interested in what is going on in foreign oil and this stuff is something that I think the Nation needs to know about.

Senator DOUGLAS. Thank you very much.

Mr. WOODS. I certainly do.

Senator DOUGLAS. Thank you.

The CHAIRMAN. Thank you very much.

Any further questions?

Senator BENNETT. I just have one: Would you like to see a bill passed forbidding the importation of any foreign oil?

Mr. WOODS. No, sir.

Senator BENNETT. That is a way to solve the problem.

Mr. WOODS. Well, that is one way; yes, sir. But the thing about it is that there should be a sliding scale whenever the domestic industry, as it is now, is sick—you see, in 1952, we had 1,200 rigs running in Texas. I don't know how many they had in Kansas. I am sure there were more than there are now, but we, today, gentlemen, and this is something I want to get in the record, we have now 480 rigs running in Texas. We are short, gentlemen, we are now short of gas reserves in Texas. Now, they talk about a lot of unconnected wells, but those wells do not have reserves, and I think the Senate deserves to know the situation in Kansas, Oklahoma, and Texas, and that we are looking—yes, we have selfish interests but at the same time, we still can't have anything if we don't have a Nation. I mean that is our position. We want to make money but we don't want to make it where it is going to hurt and harm this country from the national reserve picture.

Senator BENNETT. No other questions, Mr. Chairman.

The CHAIRMAN. Thank you.

The committee will recess until 10 o'clock tomorrow morning.

Mr. WOODS. Thank you.

(By direction of the chairman the following is made a part of the record:)

TEXACO, INC.,
New York, N.Y., December 5, 1963.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: As a citizen and taxpayer, and as chairman and chief executive officer of Texaco, Inc., I respectfully submit my views in favor of the tax rate reduction provisions of H.R. 8363, which is now the subject of public hearings before your committee, and also my views in opposition to certain other provisions that would adversely affect our company, its employees, and its shareholders.

I believe that the enactment of the tax rate reduction is imperative even though consequent reduction in Federal revenues would create budgetary deficits at currently projected levels of Government spending. In my judgment, the oppressive burden of the existing income tax rates is the greatest single barrier to the sustained growth and prosperity of the American economy. The diversion of too great a share of the national income from the private to the public sector of the economy curbs individual initiative, blunts investment incentives, and impairs the accumulation of the capital resources needed by a free economy to attain its maximum potential. Furthermore, excessive taxes encourage excessive governmental expenditures that in many instances lead the Government into areas of activity that are inconsistent with the American concept of a free society.

Some questions have been raised as to the fiscal responsibility of reducing Federal revenues through tax rate reduction without imposing specific limitations upon Federal spending. However, the record since World War II proves that high tax rates do not preclude budgetary imbalances and, indeed, may aggravate them by discouraging the optimum development of the national resources. Furthermore, fiscal responsibility must be keyed to expenditure control, both by the administration and by the Congress, in order to insure that any budgetary deficits are temporary and are kept to a minimum. I believe that the proposed tax reduction, coupled with stringent expenditure control under the concept stated in section 1 of H.R. 8363, would so stimulate the national economy that the legitimate needs of government could be financed by available Federal revenues.

Regarding certain so-called structural changes in H.R. 8363, I believe that it is self-defeating to include them in a tax reduction bill that is designed to promote the growth of our economy by stimulating individual initiative and spurring investment incentives. I refer to the provisions that would accelerate the payment of corporate taxes, that would tax employees on income imputed to them from group life insurance programs, that would restrict employee stock options, and that would repeal the 4-percent dividend credit presently allowed to individual taxpayers.

The acceleration of corporate tax payments, in the case of larger corporations, would thwart the stimulative effect of the proposed reduction in income tax rates. This speedup would prevent the corporations from realizing the full benefit of the scheduled rate reductions until after 1970.

In addition, I believe there is no justification for imposing a discriminatory tax on employees who participate in group life insurance programs. The insignificant revenue involved (some $5 million at the most) does not warrant the drastic effect that this provision would have on the expectations of many employees who for years have based their plans for the financial security of their families upon their group life insurance. As drafted, this provision would discriminate against older employees who now participate in nondiscriminatory plans. In effect, it is a penalty provision that would bear most heavily upon these career employees who, at their present ages, would find it impossible or financially prohibitive to obtain alternative insurance protection. Since such senior employees form the primary basis of the long-term growth and success of their employers, I fail to see the wisdom of imposing a prejudicial tax on their group insurance, particularly when there would be little benefit to Federal revenues.

Similarly, no additional revenues would be provided by the imposition of additional restrictions upon employee stock options. I, therefore, fail to see the purpose of curtailing the proven effectiveness of this incentive as a means of attracting and retaining the highest caliber of managerial talent. As chief executive officer of Texaco, it has been my personal experience that the incentive provided under presently permissible stock option plans has been an important factor in achieving successful operating results.

Finally, the provision to repeal the 4-percent dividend credit is in direct conflict with the basic objective of the rate reduction, which is to stimulate investment incentives for economic growth. Enactment of this provision would largely wipe out the partial relief from the double taxation of distributed corporate earnings, which was adopted in 1954 after full and adequate consideration by the Congress. It is my view that this relief should be expanded rather than diminished, and I, therefore, strongly oppose the enactment of this provision.

Texaco's views on the foregoing proposed structural changes in present law are presented in greater detail in the attached statement. A letter and statement containing our views in opposition to section 217 of H.R. 8363 and other proposals that would increase the tax burden on the oil and gas industry are being sent to you separately.

Sincerely yours,

AUGUSTUS C. LONG,
Chairman of the Board.

STATEMENT OF TEXACO, INC., WITH RESPECT TO CERTAIN STRUCTURAL CHANGES IN THE TAX LAW AS PROVIDED FOR IN H.R. 8363

Texaco believes that the provisions of H.R. 8363 which would accelerate the payment of estimated corporation taxes, change the present tax treatment of employes' group life insurance and stock option plans, and repeal the present 4-percent dividend credit should not be enacted into law. Reasons for these views are discussed below, under the section headings as they appear in the bill.

SECTION 122. CURRENT TAX PAYMENTS BY CORPORATIONS

Under present law, corporations with estimated tax liability in excess of $100,000 must pay 25 percent of such excess in the 9th month and 25 percent in the 12th month of year in which such liability is incurred. Under section 122 of the bill, starting in 1964, additional current payments would be made in the fourth and sixth months of the year. These additional payments would start with 1 percent of the tax in excess of $100,000 in 1964 and reach 25 percent in 1970, at which time these corporations would be on a fully current basis, since 100 percent of the tax liability in excess of $100,000 would be paid in the year of liability.

Texaco opposes this proposed acceleration of tax payments for the reason that it discriminates against large corporations by effectively postponing until after 1970 the benefits that would result from the scheduled reductions in corporate surtax rates in 1964 and 1965. During each of the years in the 7-year transitional period from 1964 through 1970, funds that would otherwise be available for use in modernization, expansion, and job creation would be siphoned off for the advance payment of taxes. This acceleration of tax payments is inconsistent with a tax rate reduction program designed to free our economy from an oppressive rate structure, thereby providing the capital and investment incentive necessary to sustain long-term economic growth. This provision constitutes a disguised capital levy which will be a precedent for a similar levy by foreign governments to the further detriment of the cash flow available to business enterprises operating abroad.

SECTION 203. GROUP TERM LIFE INSURANCE

Since 1920 the tax laws have been interpreted administratively to permit employees to exclude from their gross income amounts paid by employers for the purchase of group life insurance protection on the lives of such employees. Section 203 of H.R. 8363 would overrule this administrative treatment and would require employees to include in income the cost of group life insurance protection in excess of $30,000 to the extent such cost exceeds their own contributions for this insurance protection.

Under this provision, the excess of the cost of an employee's insurance protection (which increases with his advancing age and which is effectively computed on an individual rather than a group basis) over his own contributions would be imputed to him as income regardless of whether such excess is made up from the contributions of fellow participants in the group life program or from the contributions of his employer. In fact, this provision would impute income to an employee (from which his employer would be required to withhold tax) even if his employer paid no part of the cost of the employee's insurance protection. Employees whose own contributions exceeded the cost of their insurance protection, however, would be permitted a deduction for such excess.

Texaco believes that this provision unfairly and inequitably penalizes advancing age by totally ignoring the group concept of group life insurance which contemplates combining employees of all ages into one group and the payment of a single average premium for the entire group. It is particularly prejudicial and discriminatory against older career employees who in past years, in reliance upon the law in effect for over 40 years, patterned their life insurance programs on the assumption of the continued tax-free nature of group life insurance. To upset their expectations in this regard by imposing a tax on even a part of the cost of this protection at this time would raise serious personal problems of financial planning for family security at a time when comparable alternative insurance protection, if available at all, is both most needed and most costly.

Texaco believes that this provision would have a serious and deleterious effect upon employee morale to the detriment of employee efficiency and productivity. Also, the additional administrative expenses that would be incurred by employers in complying with the withholding requirements of this provision would substantially reduce, if not completely eliminate, the estimated $5 million annual revenue expected from this provision.

For the foregoing reasons, Texaco urges that section 203 be eliminated from the bill.

If, however, Congress should make any change in the present tax treatment of employees' group life insurance, Texaco believes that an exemption should be provided for insurance protection that is provided to all employees on a non-

discriminatory basis in an amount not exceeding twice annual earnings. In any event, Texaco believes that the income to be imputed to an employee should be determined on a group rather than on individual attained age basis and should in no event exceed the average premium cost for the protection provided for all employees who participate in a particular group life program.

SECTION 214. EMPLOYEE STOCK OPTION PLANS

Section 214 of the bill would impose additional restrictions and limitations on the use of employee stock options, and would not result in increased revenue. Texaco opposes changes in the tax treatment of restricted stock options under present law. It has been the experience of Texaco that the use of stock options for providing key personnel with a favorable opportunity to share in the risks as well as in the rewards of ownership has established an identity of interest between ownership and management which has given added impetus to and an incentive for maximum individual effort. Texaco believes that the additional restrictions that would be imposed by section 214 on the availability and use of employee stock options, particularly those that would extend from 6 months to 3 years the holding period of option stock qualifying for full capital gain treatment and that would shorten the option period from 10 to 5 years, should not be enacted.

SECTION 201. DIVIDENDS RECEIVED BY INDIVIDUALS

Since 1954, the tax law has accorded token relief from the double taxation of corporate earnings that are distributed to individual stockholders by excluding up to $50 of dividends from an individual's gross income and by providing a credit against tax of 4 percent of the amount of any dividends received in excess of this $50 exclusion. Section 201 of the bill would increase the present individual dividend exclusion from $50 to $100 in 1964 and later years, but would reduce the present 4-percent dividend credit to 2 percent in 1964 and eliminate the credit entirely in 1965.

Texaco believes that, contrary to the stated objectives of the entire tax reduction program contained in H.R. 8363, section 201 would reduce incentives for additional capital investment needed to sustain the long-term growth and prosperity of our economy. This provision would constitute almost a complete return to the full double taxation of distributed corporate earnings that existed prior to the partial relief provided by the Internal Revenue Code of 1954.

No other form of income is subjected to the burden of a double tax of this nature, once at the corporate level when earned, and again when distributed to stockholders. Rather than reduce or repeal the partial relief presently provided, Texaco believes that equity and fairness require that even further relief should be granted in this area. The enlightened policy of providing complete or partial relief from the double taxation of corporate devidends is followed in over 40 countries of the world.

The present relief provisions were designed to encourage equity investments, and since their enactment the number of coporate shareholders has risen to some 17 million from about 7½ million in 1954. The partial relief from double taxation of dividends undoubtedly was a contributing factor in this 10-million increase in number of shareholders. If we are to modernize and expand our productive capacity to achieve a greater rate of economic growth, we must have more investors and additional funds for capital investment. The reduction and ultimate repeal of the dividend credit would constitute a deterrent to the obtaining of such funds from equity investments.

Texaco, therefore, opposes the reduction in 1964 and the repeal in 1965 of the dividend credit and recommends that further relief be provided for the double taxation that exists in this area.

TEXACO, INC.,
New York, N.Y., December 5, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR BYRD: As chairman and chief executive officer of Texaco, Inc., I respectfully submit herewith my views in opposition to section 217 of H.R. 8363, presently being considered by your committee, and which would increase the tax burden of the oil and gas industry a estimated $40 million annually by reducing presently allowable depletion deductions. I also submit views in opposi-

tion to other of the administration's proposals which would impose additional taxes upon our industry, and which, while rejected by the Ways and Means Committee, have been discussed in your public hearings.

Changes in established domestic mineral tax policy that would increase tax liabilities of the petroleum industry would not further the stated objectives of the administration's tax program as originally outlined to the Congress in January of 1963. On the contrary, the siphoning off of funds as additional taxes would prevent modernization and expansion of the oil and gas industry and would accelerate the steady decline that has been experienced in expenditures annually made for the exploration and development of sorely needed domestic petroleum reserves. Further curtailment of these activities would increase unemployment and prejudice our national defense.

In addition, any change in our foreign mineral tax policy that would increase taxes imposed upon foreign operations of American oil companies would make these companies less able to meet the severe competition of foreign-controlled segments of the industry, let alone to cope with the ruthless economic tactics of Soviet Russia. Limiting the capability of the American companies to develop foreign petroleum reserves would damage the favorable balance-of-payments position that has been generated by their foreign activities, and would deter their making direct private investments in developing countries where most of the foreign petroleum reserves have been found. In turn, this loss of direct private investment would require our Government to provide additional foreign economic aid to these countries in order to block further inroads of Communist aggression and economic penetration.

Finally, it is my view that proposals designed to single out the petroleum industry for an increase in its tax liability are unfair and discriminatory, particularly at a time when a reduction in the tax burden of all other taxpayers is proposed. Under our present Federal, State, and local tax structures, this industry already bears at least its fair share of the total tax burden imposed on all industry generally. In fact, taking the excise taxes imposed on its products into account, the total tax burden of the petroleum industry is substantially higher than that of all other industries. These circumstances, plus the fact that the rate of investment return in the petroleum industry is at best only on a par with that of industry generally, clearly demonstrate the inequity of imposing any additional tax burden upon this industry.

For the foregoing reasons, and for those elaborated upon more fully in the attached statement, I respectfully urge that your committee reject all proposals for increasing the tax burden of the petroleum industry.

My views on other provisions of H.R. 8363 are being submitted separately.

Very sincerely yours,

AUGUSTUS C. LONG,
Chairman of the Board.

STATEMENT OF TEXACO, INC., OPPOSING SECTION 217 OF H.R. 8363 AND CERTAIN OTHER OF THE ADMINISTRATION'S PROPOSALS RELATING TO THE TAXATION OF THE OIL AND GAS INDUSTRY

Texaco believes that section 217 of H.R. 8363 arbitrarily and unfairly discriminates against the petroleum industry and should not be enacted into law. Texaco also believes that other proposals for increased taxation of income from natural resources, specifically those administration proposals which were rejected by the Committee on Ways and Means, are inimical to the best interests of the United States and should not be given favorable consideration. Reasons for these conclusions are discussed below.

SECTION 217 OF H.R. 8363

Section 217 of this bill would repeal the 1954 code provision under which taxpayers in the oil and gas industry are permitted to treat separate mineral properties that are located in the same operating unit as one consolidated property for depletion computation purposes. In lieu of this operating unit rule, section 217 would reinstate the earlier 1939 code rules under which only separate mineral properties that are located in the same lease, tract, or parcel of land may be combined for depletion purposes. In addition, section 217 would require the breaking up of existing property combinations that were formed in conformity with the law in effect since 1954, in order to comply with the more restrictive rules governing pre-1954 property combinations.

Texaco believes that this section should be eliminated from the bill H.R. 8363 for the following reasons:

1. Section 217 is discriminatory

Section 217 discriminates against taxpayers in the oil and gas industry by denying them the right to continue to compute percentage depletion deductions in the same way as that permitted to taxpayers engaged in all other extractive industries. Furthermore, this section will result in increasing the tax burden of an industry that already bears at least its fair share of the total tax burden imposed upon all industry, and would do this at a time when it is proposed to reduce the tax liabilities of all other taxpayers.

2. Section 217 is retroactive in effect

Section 217 is retroactive in effect to the extent that it requires the breaking up of existing combinations of oil and gas properties that were formed in the years since 1954 in conformity with the 1954 code operating unit rule. This will create administrative burdens and necessitate the reversal of business decisions made in reliance upon statutory provisions. Texaco believes that even if the Congress may see fit to prohibit future combination of properties for depletion purposes, it should not retroactively invalidate those combinations heretofore formed in good faith compliance with existing law.

3. Section 217 is unwarranted and not needed

Section 217 is unwarranted and not needed to resolve the administrative problems and disputes that are alleged to be involved in applying existing law and which the Treasury Department urged as a primary justification for its adoption. In fact, this provision will have no effect whatsoever on any problems or disputes under existing law. On the contrary, the enactment of section 217 will create new and greater problems and disputes for the future by requiring the breaking up of existing property combinations—with respect to which many of the problems and disputes have been finally settled—and the application of the 1939 code rules to their component properties and to any future combinations thereof.

ADMINISTRATION PROPOSALS REJECTED BY THE COMMITTEE ON WAYS AND MEANS

During the public hearings held by the Finance Committee on H.R. 8363, it was indicated that other administration proposals to increase the tax burden on the oil and gas industry would be offered as an amendment to H.R. 8363 even though these proposals were rejected by the Committee on Ways and Means.

Texaco reiterates its opposition to these proposals and discusses its reasons for thi position below under the topical headings as they appeared in the President's 1963 tax message.

A. Carryover of excess deductions

Under present tax law, in computing taxable income mineral industries are permitted to deduct a depletion allowance based on varying percentages of gross mineral income, but subject to a limit of 50 percent of net income from each producing property, determined upon an annual accounting basis. Under the administration's proposals, intangible drilling and development costs and other operating expenses incurred with respect to a property that exceed the gross income from the property in any year after 1963 would be carried forward and offset against the net income from the property in a later year or years solely for the purpose of reducing the depletion deduction otherwise allowable with respect to the property in such years. The amount so carried to any subsequent year, however, could not reduce the allowable depletion deduction with respect to the property in any such year by more than 50 percent of the amount otherwise deductible.

While the President's message referred to the mineral industry, Secretary Dillon's statement and comments make it clear that the 27½ percent depletion rate applicable to oil and gas production particularly is being singled out for attack. The proposal ostensibly leaves intact the 27½ percent rate, but its effect, nevertheless, would be a 20-percent reduction in allowable oil and gas depletion, according to the Treasury Department's estimate, or the equivalent of a reduction from 27½ to about 22 percent of gross income. In short, what the Congress has consistently refused to do in past years; namely, reduce the percentage depletion allowance for oil and gas, the administration would accomplish by indirection. Texaco believes that this proposal is inequitable and, if

enacted into law, would be detrimental to the economy of the country for the following reasons:

1. The proposal would require that oil and gas producers take into account all intangible development costs and operating expenses on a cumulative basis in computing net income for depletion limitation purposes with respect to each producing property. This would be inequitable and would distort the entire depletion computation unless gross income also were taken into account on a cumulative basis with respect to each property. It is believed that if both income and expenses were treated in the same manner, the industry's total depletion deductions ultimately allowable might well exceed those permitted under present law. Because of the complications injected into such computations and the departure from the annual accounting period concept, Texaco believes that the present method of computing depletion should be retained.

2. The increased taxes resulting from this proposal would most hurt those actively engaged in exploring and developing vitally needed domestic oil and gas reserves. This increased tax cost would add to and coincide with the heavy costs of exploration and the drilling of wells. Nonoperating interests, such as royalty owners, would not be affected directly, since they bear none of the costs of exploration and drilling, and share only in the actual production of oil and gas.

3. In order to maintain proper production levels, the producer frequently must rework wells and incur substantial maintenance costs in connection with major workovers and repairs. As these costs increased, the cash flow from the producing operations would be decreased because of the added tax burden directly attributable to such expenses. The proposed legislation would, therefore, result in postponement of major workovers and repairs, and inevitably lead to curtailment of production with a consequent decrease in income subject to tax, and so ultimately reduce Federal tax revenues. In the case of stripper wells, these results would be particularly unfortunate, since the financial impact of such changes would lead to earlier abandonment of marginal properties. The result, therefore, could well be a substantial reduction in ultimate recoverable oil and gas reserves, since over half the producing wells in this country are classified by conservation authorities as stripper wells. Loss of these reserves would reduce Federal income taxes in future years, when such reserves would have otherwise been produced.

4. The proposal would have a significant impact on secondary recovery and pressure maintenance operations, which result in the recovery of oil and gas reserves that cannot be produced by primary methods (i.e., natural flow and artificial lift). These projects require large cash expenditures for recompleting wells, drilling input wells, and installation of large surface units and plants for injection of materials such as gas, water, and liquefied petroleum gases into the reservoir. The effect of the proposal, therefore, would be to impose a tax penalty on conservation measures which add materially to the energy resources of the Nation, and result in production of oil and gas reserves heretofore written off as inaccessible. If this proposal were enacted, many major projects would unquestionably be deferred or abandoned entirely, and ultimate recoveries, and hence tax revenues, would suffer as a consequence. The potential magnitude of this loss is staggering in view of the fact that conservation experts estimate that more than one-half of our domestic crude oil reserves will ultimately be recovered by secondary recovery projects, and many of these are not yet in operation.

5. While the depletion allowance of the oil and gas royalty owner would not be directly affected by this proposal, it is not improbable that future leasing arrangements would restrict lease bonus and royalty payments. This, in turn, would adversely affect the flow of capital into the oil industry, and discourage the drilling of exploration wells, reworking and repairing existing production facilities, and instituting secondary recovery projects. Tax revenues derived by the Government from royalty owners and other owners of nonworking interests in oil and gas properties would be reduced accordingly.

B. Capital Gains on Sale of Mineral Properties

Under present provisions of the Internal Revenue Code, gain realized upon the sale of producing properties is taxed at capital gains rates. One of the changes proposed by the administration would tax as ordinary income that part of any such gain as is equal to the amount of depletion allowed after 1963 (not in excess of the tax basis in the properties sold) plus intangible development costs incurred and deducted after that date.

Texaco believes that enactment of this proposal into law would not be in the country's best interest for the following reasons:

1. Independent producers primarily would be affected by the increased taxes imposed on such dispositions, for they are the principal sellers of oil and gas properties. They are principally concerned with growth, and continuously reinvest most of the cash generated from producing operations in exploration and development of new properties. The availability of a ready market for producing properties encourages the flow of new capital into the industry from outside sources, and provides a strong incentive for the independent producer to undertake the exploration and development programs involving substantial risks, which have added materially to the Nation's reserves and productive capacity. Any changes in the taxation of gains realized from this source which would so adversely affect the sale of oil and gas properties would have far-reaching consequences detrimental to the entire industry.

2. Most operators who sell producing properties do so for sound economic reasons, not because they wish to withdraw from active participation in the industry. Profits are usually reinvested in continued search for new reserves. The proposed change would siphon off a substantial part of this venture capital which would otherwise be expended in new exploration and development. The loss of this and other sources of capital supplied by others would have economic effects far in excess of the small amount of additional tax revenues the administration estimated would be derived from this change in the tax treatment of such gains.

3. The enactment into law of any such proposal would undoubtedly encourage the sale of oil and gas properties so long as the gains are principally taxable as capital gains. But sales in later years would be curtailed when large deductions for depletion and intangible development costs incurred after the effective date of such a change would require that a substantial amount of gains would be taxed as ordinary income. Tax revenues from this source would be less rather than more, for many independent producers would be "locked in" to operations which would gradually result in liquidation of their assets, since neither reduced net proceeds realizable from sales nor the capital generated internally would be adequate to replace reserves by exploration and development.

4. At the present time, many companies are competing to purchase developed reserves, and price levels have increased substantially over the past several years. The proposed change in taxing the gain from such sales would ultimately tend to dry up this market, and the market value of all domestic oil and gas properties would decline. Producers who did choose to sell their properties would receive, after taxes, a smaller part of the total consideration paid.

5. The administration estimated that the tax burden on the producers making such sales would be increased annually by $50 million. This would be equal to the cost of about 800 average development wells. If these wells were not drilled because of the reduced amount of capital available, about 100 million barrels a year less reserves would be developed.

C. Foreign operations

Under present statutory provisions, income, deductions, and foreign tax credits of U.S. taxpayers engaged in foreign mineral operations are treated in the same manner as the income, deductions, and credits of U.S. taxpayers engaged in manufacturing and other operations in foreign countries.

The changes proposed by the administration in the taxation of foreign mineral income would—

1. Deny a substantial part of the foreign tax credit of U.S. taxpayers engaged in foreign mineral operations by limiting the amount of such credit that may be applied against U.S. tax on other foreign income to an amount determined as if percentage depletion and intangible drilling costs were disallowed;

2. Disallow foreign development costs as deductions against domestic income. Such costs would be deductible only against foreign-source income, and any excess over such income would be carried forward to subsequent years.

Experience indicates that an increase in U.S. taxes on foreign-source income of U.S. taxpayers results in an increase in the foreign taxes levied by foreign governments on such income. Texaco, therefore, believes that these proposals, if enacted into law, would not increase U.S. revenues; they would not be in the best interests of our country; and would be detrimental to our national security. Reasons for these conclusions are as follows:

1. *With respect to the foreign tax credit proposals.*—(*a*) The proposal introduces difference in the treatment of domestic and foreign income, and discriminates against the latter. This is completely contrary to the administration's position, as advanced in support of the foreign income provisions of the Revenue Act of 1962, that domestic and foreign income should be taxed on the same basis. Under the proposals, the combined foreign and U.S. tax on income from foreign mineral operations, could well exceed the amount of U.S. tax that would be payable if the same operations were conducted in the United States.

(*b*) The proposal is a back-door attack on percentage depletion, because the deduction therefor is eliminated in computing the allowable foreign tax credit.

(*c*) The additional tax burden that would be placed upon U.S. companies operating abroad would render them less able to meet the competition of foreign-controlled mineral producers.

(*d*) Foreign tax credits are presently subject to alternative limitations; i.e., computation under a per country or overall basis. The proposals introduce an additional, exceedingly complex limitation for the sole purpose of discriminating against income from foreign mineral operations.

(*e*) The proposed limitation on the foreign tax credit would reduce the amount of exploration now being conducted in foreign countries by U.S. taxpayers. Since most of the large oil-producing areas are in less developed countries, the economies of those countries would be adversely affected.

(*f*) The proposal disregards the fact that a large number of U.S. taxpayers with foreign production are conducting integrated operations, both domestic and foreign. It is wrong in principle to arbitrarily divide up such integrated operations into special forms of income for the purpose of applying the foreign tax credit. The proposed fragmentation of income of U.S. taxpayers with foreign-producing income for the purpose of limiting foreign tax credits attributable to mineral production could be only a first step in applying similar restrictions to other types of foreign endeavors. This could lead to far-reaching effects on the economies of our own country, as well as other countries with which our welfare is closely allied.

(*g*) The proposal would penalize U.S. taxpayers with large investments in oil-producing operations abroad, which were made in reliance on the more equitable rules then existing for determining allowable foreign tax credits. In fairness and equity, these rules should not be altered after such substantial financial commitments have been made by U.S. taxpayers in the development of natural resources abroad.

2. *With respect to proposals to disallow foreign development costs.*—(*a*) The proposed change in the treatment of foreign development costs is contrary to the principle that U.S. taxpayers should be taxed on worldwide income from whatever source derived. The proposal would tax income when received, but expenses could be disallowed even though actually incurred. The newcomer in foreign mineral production would be particularly penalized because he would not have foreign income against which to offset his losses.

(*b*) The U.S. taxpayer with foreign income from oil production would be penalized in that current development costs in excess of income from such source would be disallowed as current deductions, whereas manufacturing ventures and other foreign operations with current deductions in excess of current income would not be so penalized. Such deductions attributable to foreign operations other than mineral income would be deductible currently against domestic income.

(*c*) The proposed change would penalize active business income, whereas the administration has heretofore sought to discourage only the receipt by U.S. taxpayers of passive foreign income. Development costs relating to foreign mineral income can be incurred only in the active conduct of a foreign business operation, and the postponement of deductions for expenses incurred in establishing the business venture places an undue burden which would not be attributable to other forms or sources of income.

(*d*) The proposed change would make U.S. foreign mineral operations less competitive with other foreign producers in world markets. This would reduce the incentive for U.S. taxpayers to explore for and develop foreign crude production. Ultimate profits derived from the successful foreign ventures would be reduced and less Federal income taxes thereon would be collected.

(*e*) The proposal would jeopardize our national security. Foreign reserves of U.S. companies now represent a substantial part of the free world's total developed oil reserves. The availability of these reserves in times of national

emergencies and political disturbances in other countries strengthens our national security and that of other friendly nations. If tax deductions for costs incurred in the development of foreign reserves were curtailed, our foreign exploration, and hence our foreign reserves would be reduced. Our national security would be jeopardized, and Communist Russia would be aided in their economic agression against the free world.

STATEMENT BY SENATOR ALLOTT

Members of the committee may recall that early this year I introduced S. 154, which would repeal the retailers' excise tax on luggage, handbags, and similar items. I urge that the substance of the bill be considered as an amendment to the tax bill now before your committee, and that subchapter D, chapter 31, Internal Revenue Code of 1954, be repealed.

The excise tax on luggage was first imposed in 1943. Its avowed purpose was to conserve vital war materials, such as steel, nylon, leather, and so forth. It was to have been removed 6 months after hostilities ended, presumably on the assumption that the materials which were in short supply during the war would again be available in such quantity that the tax would be unnecessary and unjustified.

Despite the original purpose, the tax was extended after the war ended, at its original rate of 20 percent. Not until enactment of the Internal Revenue Code of 1954 was a change made. At that time, the rate was cut in half, to its present rate of 10 percent.

The tax has been called by some a luxury tax in recent years, since it became impossible to justify it as a wartime measure. This, in my opinion, is a misnomer. It is no more a luxury for a lady to carry a handbag, a man to carry a wallet, or either to have some reasonably convenient means of transporting clothing, than it is a luxury to wear that same clothing. The tax is simply not defensible as being imposed on luxury items.

It is, pure and simple, a revenue-raising tax. Put on this basis, I feel that it is inequitable and unjustified. There may be perhaps some argument for levying an excise tax on a product where the proceeds go to a closely related end use. But to penalize one industry with a specific tax on sales of goods produced by that industry, with the tax proceeds going to general revenue, is a hardship to the industry so taxed.

For the past 15 years there has been a very slight increase in luggage sales, despite the substantial increases in travel by Americans, both within and outside the United States. Although the Commerce Department no longer compiles figures on the retail sales of luggage, I have obtained some unofficial figures for recent years. These figures, plus the official figures for 1954 and prior years, demonstrate that the luggage industry has lagged behind the general economy in growth. The value of retail sales of luggage, in millions of dollars, is a follows:

Commerce Department figures

	Millions		Millions
1946	$188	1951	$184
1947	194	1952	190
1948	186	1953	183
1949	169	1954	183
1950	173		

Unofficial figures

	Millions		Millions
1955	$198	1959	$198
1956	198	1960	194
1957	203	1961	201
1958	189	1962	200

In summary, the present 10-percent excise tax on luggage, handbags, and so forth, is an unfair tax which has been extended beyond its original jurisdiction, and which burdens one industry. I therefore urge its termination now.

JOINT STATEMENT OF SENATORS GORDON ALLOTT AND PETER DOMINICK

We would like to express our views, during your committee's deliberations on H.R. 8363, the Revenue Act of 1963, on the subject of a realistic depletion for oil shale. It should be pointed out that Senator Dominick and I have sought to provide a realistic depletion allowance for oil shale by a bill, S. 161, which represents the principle we urge here; and that bill, to some extent, can be useful as a guideline although, from a technical standpoint, the bill would need readjustments in order to conform with present law.

Specifically, it is our recommendation that the definition of "ordinary treatment process" in the case of natural deposits used as a source of synthetic oil or gas be amended to include those processes necessary to derive oil or gas from the crude mineral product. In addition, a percentage depletion rate of 27½ percent should be applied to natural deposits mined as a source of synthetic oil or gas, in order to correspond with the historic treatment accorded petroleum. This principle is the fairest and most reasonable way to treat shale, it seems to us, and is the approach which we have suggested in S. 161 and in other bills introduced by Senator Allott in earlier Congresses. An amendment to section 613 of the Internal Revenue Code, as proposed here, would also have the salutary effect of removing existing uncertainties as to the proper point at which a depletion allowance for shale is applied.

The importance of encouraging the development of our domestic oil potential is self-evident. The benefits from a favorable development policy influence both our economic well-being and our military strength, as well as assure continued American preeminence in low-cost energy fuel technology and development. Any policy which discourages maximum American self-sufficiency on a long-range basis, with respect to oil supplies, subjects our Nation to grave risks in the event of war or other interruption of world petroleum supplies.

Estimates of U.S. total oil potential from shale is measurable in the trillions of barrels. Studies of our Nation's future energy requirements and supplies strongly support the need for prompt and assiduous endeavors to develop a commercial oil shale industry. We cannot expect oil shale to play a part in meeting tomorrow's energy requirements unless the time-consuming research and development work that is currently underway can be transformed into an effective utilization of this promising natural resource. It is essential that this committee assist in attaining the development objective, by providing a realistic and competitive tax treatment of oil shale and other minerals used in producing oil and gas.

Since early in this century, Congress has recognized the potential importance of oil shale and has enacted various legislative measures dealing with it. The most recent measure is Public Law 87-796, signed October 11, 1962, dealing with the administration of oil shale reserves and the oil shale experimental facility located near Rifle, Colo. Public Law 87-796 is designed to accomplish two objectives: First, to place the naval oil shale reserves in the same status as naval petroleum reserves; second, to eliminate the jurisdictional void which had existed, and vest in the Department of Interior authority over the experimental facility as Rifle, Colo. With respect to the second objective, the Interior Department is currently and diligently trying to follow its legislative mandate by negotiating a lease of the Rifle plant for experimental work in the utilization of oil shale. We are very hopeful that such an agreement will be worked out, and that research at Rifle will get underway. If so, this will mark another big step forward toward the ultimate realization of a commercial oil shale industry. But proof of commercial feasibility alone is only a partial inducement. This must be coupled with a realistic tax treatment which takes into account the large investment needed to produce shale oil, and permits the tax-free recovery of the capital value of such minerals by applying the appropriate depletion allowance rate at the critical point in the treatment process. The critical point, we submit, is at the end of the retorting process, where shale oil is first recovered in its raw state.

Low-gravity oil and combustible gas are derived from a bituminous substance, found in shale, that is known as kerogen. The kerogen is released from the rock by the application of heat, through a process known as retorting. It is only after the shale has been retorted that it develops characteristics that are similar to those of petroleum, and it is this point that we propose as the "cut-off" for the purpose of computing percentage depletion, and at the same rate historically allowed for oil and gas; namely, 27½ percent.

We believe that describing for the committee the complicated, expensive process which is required in order to translate oil shale into crude shale oil will point up the need for establishing the point of application of the allowance at the end of the retorting process, rather than at the mining stage where present law requires.

The Green River formation, composed of lacustrine sediments of Eocene Age in adjoining parts of Colorado, Utah, and Wyoming, is the richest oil shale resource in the United States, and possibly in the world. The U.S. Geological Survey has estimated that the rock in place in the formation represents more than 1 trillion barrels of shale oil in Colorado alone, based on laboratory Fischer assay analyses of core and drill-cutting samples. Oil shale is a compact, sedimentary rock, dark brown in color, containing organic matter known as kerogen. Thermal treatment of oil shale at temperatures in excess of 500° F. causes conversion of the organic matter to oil, hydrocarbon gases, and coke.

The processing of oil shale to produce crude shale oil is comprised of four major steps. The oil shale is (1) mined, (2) conveyed to a plant where the large chunks of shale are crushed and screened, (3) stockpiled, and (4) retorted. The shale oil from the retorts is then thermally treated and transported to other locations for refining. The spent shale discharges from the bottom of the retorts onto conveyors which carry it to a disposal area. A portion of the hydrocarbon gases evolved from the shale during retorting is recycled to the retorts for use as fuel. Each of these operations is described further.

A typical procedure for mining oil shale is the highly mechanized underground room-and-pillar method which is extensively used by the coal industry. The application of this method to oil shale has been tested by the Bureau of Mines at the Rifle, Colo., experimental station. In the mine the ceiling of the rooms was supported by 60-foot-square pillars, staggered at 60-foot intervals, and supplemented by 6-foot-long bolts driven into the ceiling. The mine faces were collapsed by blasting. The broken shale was scooped up by large power shovels and dumped into primary crushers. In a commercial mine, crushed shale would then be conveyed to vertical shafts called raises which would feed a common conveyor belt housed in a tunnel located below the formation. Shale from the tunnel would receive secondary crushing, be screened, stockpiled, and blended to provide a uniform charge to the retorts.

There are more than 2,000 patents describing methods for restoring oil shale. However, in this country only three methods have progressed to a stage of development where they might become of commercial significance in the reasonably near future. The Bureau of Mines gas-combustion retort, which is similar to an iron ore blast furnace, is typical of these. In the Bureau's retort, crushed shale (one-half inch to 3-inch particles) enters at the top, and flows down through the retort by gravity. The light hydrocarbon gas formed in the retorting operation is recycled to the bottom of the retort where it exchanges heat with the retorted shale. As the heated recycle gas flows upward, it is contacted with air and burns, forming a narrow, high-temperature zone across the middle of the retort. The hot combustion gases from this zone continue upward and furnish the heat necessary to pyrolyze the kerogen from the raw shale. The shale oil vapors are cooled by the cold raw shale in the upper part of the retort and are finally removed from the retort as a fine mist, which is precipitated as a liquid and stabilized as raw shale oil in subsequent processing equipment.

The raw shale oil produced from retorting is normally of relatively high pour point (75° to 90° F.) and must be thermally processed before it is suitable for pipelining. Conventional visbreaking or coking to a pour point of 30° F. are the generally recommended methods of processing.

It is clear that to produce the end result; namely, raw shale oil, which like other fossil fuels is a nonrenewable asset, it is necessary to go through far more steps both complex and costly than in any other endeavor of a related kind. This accounts for the need to modify present law respecting shale and make it responsible to reality.

Quite clearly, the extraction process, which ultimately renders crude shale oil ready for refining, requires a much heavier expenditure in the retorting end than in the mining per se. So long as the law does not allow an adequate depletion allowance for shale, at the retorting end of the extraction process, there will continue an effective block in the path of oil shale development as an industry.

When we refer to oil shale development, we are speaking of the largest known untapped energy source in our Nation. We are speaking of a potentially great industry that holds real promise of new job prospects, that offers tremendous

opportunity of economic progress for the benefit of the entire Nation and that represents a major addition to our defense resouces. We therefore urge that this committee give serious attention to amending H.R. 8363 in order to incorporate the recommendations that are made herein.

THE STATE OF COLORADO,
DEPARTMENT OF REVENUE,
Denver, November 26, 1963.

Hon. GORDON ALLOTT,
U.S. Senator,
Senate Office Building,
Washington, D.C.

DEAR MR. ALLOTT: I have learned that section 207 of the revenue bill of 1963 contains certain elements which will, in my opinion, weaken the tax base for the State of Colorado. I refer particularly to the disallowance as itemized deductions of amounts paid to the State for motor fuel taxes, tobacco taxes, automobile driver licenses, and alcoholic beverage taxes.

Any extension of law which would disallow State or local taxes as legitimate taxes from the Federal income tax will make it more difficult for the State of Colorado to care for its present and future financial problems. It is at best difficult to levy a tax but when in effect we impose one tax on another there is greatly increased resitance.

It seems to me these local taxes should continue to be allowed as reductions of Federal income tax liability.

Cordially,

HUGH H. C. WEED, Jr.,
Director of Revenue.

STATEMENT SUBMITTED BY STARK FOX FOR OIL PRODUCERS AGENCY OF CALIFORNIA

Oil Producers Agency of California is pleased to have this opportunity to express its views as to the effect of an additional tax burden upon the independent oil producer in California, which would have been the result of the enactment of tax legislation in the form originally recommended by the Treasury Department. We ask that this statement be made a part of the record of the Senate Finance Committee hearings on H.R. 8363.

Oil Producers Agency of California is a trade association of independent oil producers in California whose oil production is approximately 25 percent of the State total, and whose position is simply that to add a further tax burden on an already depressed industry would defeat the announced purpose of the so-called tax reform program, that purpose being to stimulate the economy.

Continuously since 1957, the economic health of the independent producer in California has been deteriorating. He has suffered the deepest erosion in crude prices of any oil-producing region in the United States.

The average value of oil at the wellhead in California, according to the mineral information service of the State division of mines, is $2.44 per barrel today, 61 cents below the $3.05 per barrel in 1957. This is a cut of 20 percent, and price cuts by gravity have ranged from 35 cents per barrel in the lighter grades to 76 cents per barrel in the heavier.

The dampening effect of these price cuts is evident. California independent producers completed 947 oil wells in 1957; they completed only 708 in 1962. California production was 929,000 barrels per day in 1957, of which 410,000 barrels per day or 44 percent was produced by independents; it was 810,000 barrels per day in 1962, of which 319,000 barrels per day or 39 percent was produced by independents.

INDEPENDENT PRODUCTION DROP

Thus, because of the price cuts already suffered, independent producers in California have lost 91,000 barrells per day of production out of a total drop of 119,000 barrels per day. Further, according to the best available figures, some 370 producing companies have disappeared from the California producing scene since 1955, 38 of them in 1962.

There is much more evidence that the independent oil producer in California cannot stand an added tax burden to add to his cost of operation; that his eco-

nomic condition is weak, rather than strong. Independent producers operated 20,199 producing wells in 1957; they operated only 19,039—1,160 fewer—in 1962. The average daily production of these wells was 25 barrels in 1957; it was only 16 barrels in 1962, a drop of 9 barrels per well per day, which is a drop of 34 percent.

A further reflection of the deterioration in the California oil producing industry is seen in the decline in exploratory effort. In 1957, 584 exploratory wells were drilled; that number had dropped to 417 in 1962, in spite of the fact that district V, which is made up of the States of Alaska, Arizona, California, Hawaii, Nevada, Oregon, and Washington, is officially recognized as an oil-deficient area by the Federal Government.

It is unnecessary to detail all the ill effects of this decline in the California producing industry. As a final example, however, employment under the category "crude petroleum and natural gas production" as reported by the California Division of Labor Statistics dropped from 26,000 in December 1957 to 20,700 in December 1962, a loss of 5,300 jobs in the period.

These brief statistics are cited to show the committee that the recent history of the oil-producing industry in California is one of regression rather than progress. It is obvious that, with increasing costs and lowered prices for crude oil, the California producing industry has found the cost-price squeeze becoming increasingly tighter, with the predictable result that further deterioration will ensue.

This, quite obviously, is contrary to the administration's policy, not only as to taxes, but as to the oil industry generally. The oil import program was enacted and is in effect only because the Federal Government has found that a strong and vigorous oil industry is essential to the Nation's security; the announced purpose of the tax-reform program was to stimulate the Nation's economy. To place an additional tax burden upon the oil industry at this time would defeat not only the purpose of the tax-reform program, but also the purpose of the oil-import program.

We urge the committee to turn down those parts of H.R. 8363 which would increase oil industry taxes. We have tried, in this brief statement, to indicate some of the effects increased taxation would have upon the California oil industry; we know that similar effects would be felt by the national oil industry. While we have confined our statement to the California oil industry, we would like to emphasize that we concur in and support the statement presented to this committee by the Independent Petroleum Association of America, which factually describes the present condition of the national oil producing industry and the detrimental effects of an added tax burden upon that industry.

STATEMENT OF ELMER L. HOEHN, EXECUTIVE SECRETARY, INDEPENDENT OIL PRODUCERS & LANDOWNERS ASSOCIATION, TRISTATE (ILLINOIS-INDIANA-KENTUCKY)

My name is Elmer L. Hoehn, executive secretary, Independent Oil Producers & Landowners Association, tristate (Illinois-Indiana-Kentucky), Evansville, Ind. This statement represents the views of our association concerning the sections on oil and gas in the Revenue Act of 1963, H.R. 8363.

Abundant supplies of oil and gas in the United States have been available to the consuming public at relatively low prices, enabled by the tax treatment that was established and maintained without change by the Congress. In the Indiana-Illinois-Kentucky tristate area, the independent producer has found most of the new oil. He is highly regarded as a hard-working, chance-taking American who is willing to risk his last dollar searching for oil. His net worth is not measured in millions. A large part of his time is spent attempting to convince his financial sponsors that to make one more venture will be the end of the rainbow.

He is generally in debt but is at the same time regarded as a good credit risk. His efforts have given our section of the Nation one of our greatest economic assets. As a result, there has been a great flow of revenue into the State and local tax treasuries, into the banks, stores, schools, churches, hotels, restaurants, and into many community projects. A large labor force is employed in oil. Over 16,000 people are directly employed in our area and an equal number in the oil services industries, cement, machinery, steel, and transportation. In all, there are over 100,000 family population living off oil work and income.

In Illinois, oil is the largest mineral industry. There is oil and gas production in 46 of the 102 counties. The average daily crude production per well is 5.4 barrels, and 99.8 percent of all wells are on artificial lift. This means that virtually all of the wells have a small daily production and high operating costs, and are vunerable to any tax changes or any other adverse economic conditions.

Kentucky producers generally, because of the low production rate, 2 barrels per day, determine depletion either on a cost basis or on a 50 percent of net income basis. Operating costs are higher compared to other areas. The potential income is small.

Oil is not found as readily in our area as it once was. The search is more difficult; it is more expensive. Operation of production after discovery is more expensive. As of January 1, 1962, Illinois had 39,455 oil wells, of which 99 percent were stripper wells; on January 1, 1963, Illinois had 30,000. Kentucky had 25,121 wells, of which 95 percent were stripper wells on January 1, 1962; January 1, 1963, Kentucky had 19,800 wells. On January 1, 1963, Indiana had 5,887 wells and 1 year earlier there were 6,271, of which 98 percent were stripper wells. The tristate area had a decline in 1 year of 14,700 wells. Yet the efficient operation of existing wells in 1962 produced 103,357,370 barrels of oil of a value of about $324 million for the benefit of ou area and the United States. There have been 3,085 million barrels of oil produced, worth about $6,593 million, a part of which helped pow - the Allies through World War II. In fact, Mount Vernon, Ind., at that time developed into the largest inland oil shipping port in the world because of submarine action.

Landowners and farmers alone have received $824 million from the efforts of the producers. Over 7,000 feet of sedimentary deposit in our basin remains to be explored. We have substantially produced to a depth of only 3,600 feet.

The daily production from this area is about 300,000 barrels from 56,000 wells. This is an average of 5 to 6 barrels per well per day including the full benefits of secondary recovery operations. These 56,000 wells would never have been drilled had it not been largely for the existence of percentage depletion providing the incentive.

During the peak years and war years, 9,881 wells were drilled, last year nly 4,478. During the peak year, 2,061 wildcats were drilled, last year only 1,003. During the peak year, 137 rotary rigs were running in the area, last year only 45. Incentive is needed more than ever before to keep oil-finding independents in the continuing search for oil. Drilling contractors have been living off their depreciation; 92 percent of all oil service company business in the area is with the independent.

The price of crude oil is about the same as in 1956. Production labor costs have increased 20 to 27 percent; material, supply costs have increased 10 to 33⅓ percent, and oil field service costs have increased 10 to 20 percent during this period.

One of the greatest fallacies has been to speak of the 27½-percent depletion allowance. A survey of actual tax returns of independent oil operators in the area over the past 10 years deflects a percentage depletion of 13 to 20 percent instead of 27½ percent.

Independent producers of the tristate area drill back into the ground all of the 13- to 20-percent depletion. They drill back most of the net excepting enough to modestly live on. They drill into the ground all incentive capital they can raise from others.

Tremendous strides have been made by the petroleum industry. Petroleum now and in the foreseeable future will continue to supply nearly three-fourths of the Nations energy supply. The Congress in the interest of national security and continued peacetime prosperity, with particular concern for future petroleum supplies from within the national borders, should affirm the economic principles which they have done so many times before. This country's adequate supply of oil which will power U.S. leadership in peace and war will in very large measure result from a determined effort to restore a momentum which has slowed in exploration drilling and producing since 1957. Last year, for the first time, the United States did not add significantly to new reserves over that being used. The cost of finding and producing a barrel of new reserves is greater than the price received.

The percentage depletion incentive is not adequate. Increasing the incentive is necessary so that the harder-to-find reserves, whether they be deeper, below the ocean floors, or more inaccessible, will be sought and found.

The great challenge, it seems to us, is to accelerate domestic growth in petroleum production that will stay well ahead of demands of our booming population in the years ahead.

COMMENTS AND RECOMMENDATIONS REGARDING H.R. 8363, THE REVENUE ACT OF 1963, SUBMITTED BY THOMAS J. GRAVES, GENERAL CHAIRMAN, COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The comments, recommendations, and observations on H.R. 8363 and certain of its amendments contained in this statement represent the opinion of the committee on Federal taxation of the American Institute of Certified Public Accountants.

The American Institute of Certified Public Accountants is the sole national organization of professional CPA's in this country. It has over 47,000 members. Its 66-member committee on Federal taxation has been authorized by the institute's governing council to speak on its behalf in matters related to Federal taxation. The committee is carefully chosen to provide representation from all parts of the country, from all sizes of professional CPA firms, and from firms rendering professional services to all kinds of industrial and other organizations, both large and small.

This statement is divided into three parts:

I. General conclusions on H.R. 8363.

II. Recommendations on provisions and amendments of H.R. 8363 of particular interest.

III. Technical comments on specific provisions of H.R. 8363.

PART I. GENERAL CONCLUSIONS ON H.R. 8363

OBJECTIVE AND SCOPE OF H.R. 8363

During the period prior to the hearings that led to the introduction of H.R. 8363 by the Committee on Ways and Means, general agreement had been reached among representatives of all segments of the country's economy—government, business, labor, and consumers—on the importance of tax revision and reform as a means of stimulating economic growth. It was in reflection of this general agreement that President John F. Kennedy, on January 24, 1963, sent to Congress his proposals for tax changes intended to strengthen the vigor of our economy, increase job and investment opportunities, increase incentives to risk taking, and increase productivity. Our committee agrees with the importance of these general objectives. We agree also that an appropriate revision of tax rates would do a great deal to achieve them.

As certified public accountants serving taxpayers in many industries and in many parts of the country, we are well aware of the restrictive and inhibiting effects of the present tax law upon our business economy. This negative force has four principal aspects:

(1) The overly rapid progression of income tax rates to an excessively high level reduces incentives and initiative and limits internal generation of the funds necessary to growth.

(2) Unwarranted benefits made available to some taxpayers or seized by others through careful planning have a tendency, while rewarding those who obtain them, to cause the tax laws to bear even more heavily on others who do not enjoy them.

(3) The influence of tax provisions on business decisions may be so great that it becomes advantageous to set aside normal and sound business considerations when faced with the overwhelming importance of tax results.

(4) Complexities of the law, which have increased at an accelerated pace in recent years, demand too much of the time and abilities that should be devoted to more productive pursuits. The worth of any major tax revision should be measured by the extent to which it solves these problems and by whether, in fact, it may add to them instead of providing solutions.

In addition, tax legislation should meet equally important standards of fiscal policy, such as avoidance of the inflationary thrust that could come from a succession of seriously unbalanced budgets. In the light of a budget already out of balance, we believe that every effort should be made to hold expenditures to

reasonable levels while the stimulative action of proposed tax reduction has a chance to take effect. With a substantial deficit in prospect, it seems especially important that rates should be reduced only in a way best designed to advance the economic growth of the country.

GENERAL ACCEPTABILITY OF RATE REDUCTIONS

If the provisions of H.R. 8363 for rate reductions and revision are modified to reflect several major recommendations which we will present in these comments, we believe the changes should be adopted.

Although we recognize the importance of both the stimulation of consumption and the provision of increased incentives for productive investment, we question whether the proposed changes allocate enough of the planned revenue reduction to those taxpayer groups best able to advance economic growth through the investment of funds and through their response to the incentives of more reasonable rates. The provisions of H.R. 8363 seem, on balance, to provide disproportionate relief at the income levels where stimulation of consumption would result.

We suggest that the following changes would be desirable:

(1) Provide a degree of tax relief in the middle income brackets at least equal to that proposed for those who pay taxes at the lowest rates. A disproportionate reduction in the bottom brackets does not seem warranted in the light of other provisions (such as the provisions for a minimum standard deduction and for liberalization of the child care deduction) that would provide additional relief to low income taxpayers at the cost of further narrowing of the tax base.

Even in the revised rate structures of H.R. 8363, the progression of tax rates is particularly inhibiting in the middle brackets. At the very least the degree of change should be no less in those brackets than in the lower brackets, thus strengthening needed incentives.

This is not inconsistent with reduction of the highest individual tax rates in an even greater degree. The additional reduction in the highest brackets would have a small revenue impact and it would remove the worst feature of the present rate structure, which tends to eliminate income-producing incentives for the most successful.

(2) The proposal to reduce normal tax rates for corporations by 8 percentage points while reducing the general corporate rate by only 4 percentage points seems unwarranted. It would result in sharper progression in the rate structure than at present.

We suggest limiting the reduction in the normal tax rate to 4 percentage points, the same change as is proposed for the general corporate rate. This would provide a reduction of 13.3 percent in the taxes of corporations with taxable incomes of $25,000 per year or less, as compared with a reduction of 7.7 percent for large corporations and a reduction of 26.7 if the 8-point reduction in the normal rate were adopted.

(3) There should be sufficient modification of the planned acceleration in corporate tax payments to permit affected corporations to retain some of the benefits of the tax rate reductions proposed for them. The acceleration of payments during the years 1964–70 would result in some corporations paying more taxes during some of those years than they would pay without the enactment of H.R. 8363.

Although information developed by the staff of the Joint Committee on Internal Revenue Taxation indicates that corporations would not actually pay more tax if their estimates were based on 75 percent of the tax above $100,000, in many instances this basis for estimating will not provide adequate protection against penalties because of the uncertainties of attempting to determine income at interim periods, especially early in a year. As is indicated in the staff study, if current payments were based on 100 percent of the tax above $100,000, some corporations would make greater payments in 1966, 1967, and 1968 than in 1963.

There are other problems in the proposed acceleration of corporate payments. The requirement of an initial estimate by April 15 for a calendar year corporation would mean that many would have to base their computations on operations for the first 2 months of the year, since they might require more than 15 days to close their books and prepare the necessary data for the initial 3-month period. This could mean that the April 15 estimates would be relatively meaningless. Two months of operations may not provide an adequate basis of pre-

diction because of fluctuations in income and the difficulty of identifying trends in operations based upon such a short period. The available procedure for obtaining refunds of overpayments would not solve this problem. The probable excesses may not relate to anticipated total payments for the year, but only to a proportionate part of 70 percent thereof, which is the basis of estimating. In addition, the procedure for making refunds would not operate rapidly enough to provide immediate relief.

Some corporations would not have funds available to meet the accelerated payments and in some cases they may have difficulty in raising the necessary funds. In any event some of the payments would be made from amounts that otherwise might be available for business expansion. Thus, acceleration would tend to defeat the objective of providing greater incentives for investment.

We suggest that corporate estimated payments be made in equal amounts of one-third, with the 1st payment in the 6th month of the taxable year and the 2d and 3d payments in the 9th and 12th months. This would reduce the drain on corporate funds and would ease the problem of estimating at a time too early in the taxable year to determine what the income of the year may be.

STRUCTURAL REVISIONS OF PARTICULAR INTEREST

In part II of these comments we present our recommendations on those sections of H.R. 8363 and those proposed amendments which appear to us to be particularly worthy of your favorable action because they would improve the structure of the tax law, significantly remove serious inequities, or contribute substantially to simplification. They are—

1. Section 202(a): Simplification of investment credit.
2. Section 221: Income averaging.
3. Section 222: Consolidated returns and intercorporate dividends.
4. Amendment 229: Entertainment, travel, and gift expenses.
5. Amendment 319: Depreciation guidelines.

OTHER STRUCTURAL REVISIONS

Although the planned rate reductions would, with the modifications we have suggested, represent a substantial and worthwhile response to general dissatisfaction with high tax rates, the remainder of the revisions, considered as a whole, do not meet adequately the very pressing need for reform in the structure of our tax system. Some provisions of H.R. 8363 would terminate special benefits available for some taxpayers, but other provisions would extend special benefits, and in some instances the bill would have the effect of terminating special benefits for taxpayers at one income level while retaining similar benefits for other taxpayers. While some of the structural revisions represent improvements, they do not even approach a redistribution of the inequitable burdens of the tax system or the problem of the weight that must be accorded the system in developing plans for business operations and designing the form of business transactions.

Of even greater concern to our committee is the fact that the bill not only would make no real move in the direction of simplification of the code but would actually add a great deal to its complexity. It would continue the trend of recent years of adding a multiplicity of detailed provisions to the law.

We believe some of the proposed changes should be deferred for further study and for further consideration of the extent to which they should be carried in developing solutions to the problems to which they are directed. There is a further question with respect to several of the provisions as to whether the improvements achieved and the revenue recovered are sufficiently significant to justify the further compounding of complexities.

We suggest, therefore, that no action be taken on the following provisions pending further study of the need for them and of the possibility of making them less complex:

1. *Group term life insurance purchased for employees.*—The proposed change in the treatment of group term life insurance deals with only one small segment of the broad question of employee compensation and fringe benefits. We believe this change should be deferred until the whole area can be reviewed and a comprehensive plan developed for any necessary revisions in the treatment of employee compensation. In addition, as is explained further in the comments in part III, we question the advisability of two of the key features of section 203. In view of these questions and the need for additional study, the estimated

revenue of $5 million that would be obtained from this revision does not seem to warrant its adoption at this time.

2. *Interest on certain deferred payments.*—The provisions of section 215, which would require imputation of interest in connection with sales of property under deferred payment contracts, seems to be an attempt to fit all business transactions of this type within a preconceived idea as to what their nature might be. This additional complexity in the tax law does not seem warranted, either by the existing abuses or by the revenue effect, since it has been estimated that the revenue effect of the change would be negligible.

The added complexities would be particularly unfortunate because they would affect many taxpayers, including taxpayers who do not engage in business. The necessity placed upon these taxpayers of determining "unstated interest," which in turn requires the computation of present values of installment payments, means that they would be faced with problems they are not equipped to handle, thus being forced to seek professional assistance with what otherwise might be relatively simple tax returns.

There mere absence of a stated interest element in a deferred payment transaction does not necessarily mean that the buyer and seller are conniving to avoid the passage of ordinary income. These arrangements usually are determined at arm's length. It seems just as incorrect to impute interest where interest is not actually intended, which is the effect of section 215, as to fail to recognize an interest element that happens to be unstated by the contracting parties. In any event, if it is believed that there are serious abuses in the present pattern of transactions, a more reasonable solution would be to impute interest only in those types of situations where abuses are believed to exist.

In any eevnt, it should be unnecessary to use a rate of interest for purposes of imputation that is any higher than the prime commerical short-term rate. This would avoid to some extent the complexities provided by the proposed provision.

3. *Personal holding companies.*—We do not wish to disagree with any reasonable measures to further minimize the extent to which passive or investment income can be sheltered in closely held corporations in order to take advantage of the lower corporate tax rates. However, it does seem that the mere bulk and intricacy of the additional provisions of section 216, which cover 44 pages in the bill passed by the House of Representatives, are sufficient in themselves to suggest that they require substantial further study before they are adopted.

Several of the proposed provisions should be reconsidered because they are overly restrictive, representing what appears to be an overreaction to the ills they would seek to cure. Others seem to add unnecessarily to the complexity of the personal holding company rules. While we have commented in part III of these comments on those provisions to which we take particular exception, in view of its complexity we believe that all of section 216 should be deferred for further study.

TECHNICAL COMMENTS ON SPECIFIC PROVISIONS

In addition to the preceding comments on the basic structural revisions of H.R. 8363, in the accompanying part III of our comments we present suggestions for technical improvements in several of the provisions of the bill.

Part II. Recommendations on Provisions and Amendments of H.R. 8363 of Particular Interest

SIMPLIFICATION OF INVESTMENT CREDIT

Sections 202 of H.R. 8363 would repeal the requirement that the basis of assets be reduced by the amount of the investment credit that arose as the result of their acquisition. We urge that this provision be approved by your committee.

The adoption of total cost as the basis for computing depreciation would permit realization of the full beneficial effect of the investment credit and would be welcomed by business taxpayers, large and small, as a major simplification in the accounting for machinery, equipment, and similar assets. It would put an end to the burdensome complexities that result from the present provisions of the codes.

A. *Full beneficial effect of credit should be realized.*—Although the investment credit was adopted in 1962 to stimulate industrial expansion, and there is evidence that it was successful in encouraging investment, thus contributing to

the satisfactory level of business operations during the past year, the structure of the credit provision is such that its stimulative force will be blocked more and more in the future by the action of the provision for reduction of the basis for depreciation.

The effect of the reduction of basis by the amount of the investment credit is that approximately one-half of the credit is recaptured by the Treasury over the life of the assets on which the credit is based. The basis reduction gives one-half of the investment credit the general status of an interest-free loan from the Government, repayable over the life of the related assets. As additional investments are made each year in machinery and equipment, the amounts to be repaid (because of the basis adjustment) will grow larger and larger, with the result that the net amount realized from the credit on these future investments will diminish. Over the replacement cycle of the machinery and equipment of a business, the stimulative affect of the credit will gradually decrease and, when a full cycle has been completed, the credit will tend to be only 50 percent effective. Thus, the value of the investment credit as an economic stimulant will decline from year to year.

The repeal of the requirement that the cost of assets be reduced by the investment credit will permit the credit to exert the full beneficial effect upon the economy that was originally intended.

B. *Present law adds complicated and costly recordkeeping burdens.*—The basis reduction requirement has caused substantial complications in the accounting for depreciable assets. The cost of maintaining the necessary additional records is believed by many taxpayers to offset practically all of the benefits of the investment credit. Had the credit been elective, many taxpayers would have rejected it rather than assume the additional recordkeeping burdens.

The requirement that basis be reduced causes a number of differences between the books and the tax return in accounting for the assets. While these differences are not complicated as related to a single asset, the large number of assets used by most businesses causes a serious problem since, for all practical purposes, records must be maintained of both the book and tax basis of each asset. The following example shows the kinds of differences that arise:

	For books	For tax return
Cost of asset purchased Jan. 1, 1963	$3,000	$3,000
Investment credit applicable (expected to have 10-year life)		210
Basis for computing depreciation	3,000	2,790
Asset sold on Jan. 1, 1969, for $1,500 (6 years of depreciation based on 10-year life)	1,800	1,674
Adjusted basis before recapture	1,200	1,116
Restore ⅓ of investment credit because asset held only 6 years		70
Depreciated cost at date of sale	1,200	1,186
Sale price of asset	1,500	1,500
Depreciated cost	1,200	1,186
Profit on sale	300	314

The differences between the books and tax return in accounting for this asset are four:

1. For tax purposes the $210 investment credit is applied in reduction of the cost of the asset.
2. In each year the book depreciation is $300 as compared with tax depreciation of $279.
3. In the year of sale one-third of the investment credit is required to be restored to the tax basis.
4. The gain on sale of the asset is greater for tax purposes than is reflected on the books.

Even though the majority of taxpayers compute the provision for depreciation on a composite or group basis rather than on individual items, the differences set forth above must be considered under those methods when an asset is disposed of and the results of the disposition are recorded. Furthermore, the possibility that a part of the credit may have to be restored makes necessary the

maintenance of records that permit the identification of assets retired prematurely.

At best, proper accounting for depreciable assets involves substantial time and expense because of the sheer number of assets used by most businesses. Differences, such as the ones illustrated, add to the time and cost of maintaining records.

A question might be raised as to why a business does not keep its depreciable asset records on the tax basis and eliminate these differences. Although some taxpayers may do so, many are subject to other conflicting accounting requirements which must be observed. For example, any company that is required to file annual statements with the Securities and Exchange Commission must report depreciable assets in its financial statements at full cost and not on a tax basis.

The depreciation guidelines released in 1962 by the Treasury Department (Rev. Proc. 62-21, 1962-2 CB 418) encourage some simplification of recordkeeping for depreciable assets by establishing guideline lives which may be applied to composite or group asset accounts. Where composite or group accounts are employed for depreciation purposes, no identification of individual assets is required; however, identification of the cost of individual assets becomes necessary in accounting for the investment credit. Thus, the two procedures tend to work at cross purposes.

Additional accounting complications arise in the computation of allowable depreciation for State income tax purposes. The taxpayer will be required to disregard the investment credit adjustment to basis where no similar basis adjustment is applicable under State law. To meet this problem a separate set of depreciation records may be necessary, adding to the recordkeeping burdens.

There are still other complications. Lessees of property must keep detailed records in order to adjust their rent deductions. "Conduit" entities, such as partnerships or subchapter S corporations, have particularly bothersome problems as a result of actions by their taxpaying participants; e.g., application of the limitation on the credit available for used property where an individual taxpayer belongs to more than one partnership.

INCOME AVERAGING

A plan for averaging income would provide much needed fair treatment for those whose incomes fluctuate widely from year to year. For a number of years we have advocated an averaging plan of general application to replace the limited averaging provisions available under present law. Income averaging is essential to do justice to taxpayers subject to wide fluctuations of income, particularly where they have only a few years of peak earnings. Accordingly, we welcome in principle the plan contained in H.R. 8363 and we recommend its adoption.

We have reservations, however, as to the adequacy of the plan contained in proposed section 221. It is so restrictive that it would not provide effective relief in many situations where relief should be granted. We urge as an alternative a plan that would permit averaging over selected blocs of 5 years with no one year being included in more than one bloc of 5.

A. *Plan proposed in section 221 is deficient.*—The proposed averaging provisions would require that taxable income for the current year exceeded 133⅓ percent of average taxable income for the prior 4 years and that the excess amount subject to averaging exceeds $3,000. Although the $3,000 floor would help to avoid unimportant adjustments, the limitation of income subject to adjustment to that which exceeds 133⅓ percent of the prior year's average tends to reduce the availability of relief. We grant that some exclusion is desirable to avoid refunds from minor fluctuations in income but it would seem that a 5-percent exclusion would be sufficient when coupled with a floor of $3,000.

A more serious flaw in the plan is its failure to provide a device that would permit averaging over a period of years that extends beyond the years in which peak earnings are achieved. Some relief would be given in the first few years of peak earnings but none would be available if later years were followed by a substantial decline in earnings. This is because the year in which relief is to be granted would always be compared with past years. We feel that this defect would be overcome in a plan that we have recommended in the past, which would permit taxpayers to average overselected blocs of 5 years with no one year included in more than one bloc of 5.

B. *Recommended substitute for proposed plan.*—The plan for averaging which we recommend contains the following features:

1. A 5-year bloc system of averaging made available, on an optional basis, to individual taxpayers, giving a taxpayer the privilege of using this system at intervals of 5 years or more. Once a particular year was included in a bloc it would not be included in a subsequent bloc. This system would make relief available to taxpayers whose incomes have declined.

2. The taxpayer would use the averaging system to determine the excess of the tax payable on the income of the most recent 5 years over the amount that would have been payable had one-fifth of that income been reported in each year. This would be done by totaling the taxable income for the 5 years, dividing the total by 5, applying to the average income a tax at average rates, multiplying the average tax figures by 5, and finally, comparing that total with the total tax actually paid for the 5 years. The use of average rates (which, based on a special formula to be set forth in the code, would be prescribed and kept up to date by the Internal Revenue Service) in computing the tax on average income would avoid any difficulty that might arise because of a change of tax rates during an averaging period. When a change in marital or other tax-significant status occurred during the averaging bloc, the 5-year span would be divided into shorter averaging periods.

3. The excess of the tax paid over the total average tax as computed above would be refundable to the taxpayer only to the extent that it exceeded 1 percent of the total taxable income for the 5-year period, or approximately 5 percent of the average for the period. This would introduce a tolerance factor which would limit the formula's use to taxpayers who would otherwise suffer severe hardships because of variations in annual income. Legislatively, this tolerance factor could be varied, making it higher or lower than the one suggested.

4. Administratively, the taxpayer could be required to file his averaging schedule with the tax return for the last year in the 5-year bloc selected by him, so that the refund could be applied against the tax due from him for the final year in the bloc computed in the regular manner. Any excess could be made subject to the same election as to refund or application against estimated tax as is presently called for in the case of overpayments due to excess withholding or estimated tax payments. This system limits the number of tax adjustment claims and also prevents the use of low-income years in more than one average.

C. *Comparison of both plans.*—A comparison of the two methods for providing equitable results from income averaging indicates that proposed section 221 is far more complex than the 5-year bloc system. If income averaging should be designed to treat everyone as nearly equally for tax purposes as possible, without regard to the type of income involved, and at the same time take a form which is workable, the 5-year bloc system should be more acceptable than the proposed provisions of section 221. The 5-year bloc system requires no differentiation as to sources of income; it does not burden the Internal Revenue Service administratively, since it contains a tolerance factor; and averaging can be elected only once by a taxpayer in a 5-year period. The bloc system also gives consideration to decreases in income which may occur in future years, making relief available to taxpayers whose incomes have declined, while the provisions of proposed section 221 relieve only those whose incomes are increasing.

Furthermore, the 5-year bloc system logically compares an average of income over a period of 5 years with the taxes paid applicable to such income for the same period of years. The averaging resulting from the income and tax comparison would seem to be more equitable than the averaging of income only, as is proposed by the provisions of section 221.

D. *Technical improvements in section 221.*—Several suggestions for improvements in the structure of section 221 and for the elimination of some of its complexities are presented in part III of these comments.

CONSOLIDATED RETURNS AND INTERCORPORATE DIVIDENDS

A. *Eliminate 2-percent penalty on consolidated returns.*—The effect of section 222 of H.R. 8363, providing for repeal of the 2-percent penalty tax on consolidated returns, would be to encourage the filing of consolidated returns by qualified affiliated groups of corporations.

We support this proposal because we believe that consolidating the results of operations of a group of commonly controlled corporations into a single economic unit for tax purposes may result in reflecting taxable income of such a group more clearly. A penalty tax should not be asserted if taxpayers choose to file consolidated returns as a more accurate measure of income.

Regardless of whether it is decided to enact section 223 (relating to separate $25,000 surtax exemptions of a controlled group) the 2-percent penalty tax is not justified, since under existing law the individual surtax exemptions are waived where a consolidated return is filed. In effect, the affiliated group is treated as if it were a single corporation conducting operations through divisions, rather than through separate corporations. In a divisional situation no penalty tax would be exacted.

The filing of a consolidated return does permit losses of one or more members of the affiliated group to be offset against profits of other members of the group. It also permits tax-free payments of intercorporate dividends. However, this encourages a free flow of funds from one business operation to another, just as if the separate operations were conducted by divisions of one corporation. The alleged tax benefit from permitting the losses of one or more members to offset the profits of other members may not, in fact, exist. The regulations provide for a reduction in the basis of the stock or obligations of a loss corporation (in the hands of an affiliated corporation holding such stock) to the extent of losses availed of during a consolidated return period.

B. *Intercorporate dividends should be free of tax.*—In addition to supporting enactment of section 222, we recommend passage of legislation eliminating the tax on intercorporate dividends paid by members of an affiliated group of corporations, even though a consolidated return is not filed, to further harmonize the treatment of affiliated groups of corporations.

If the affiliated group elects not to file a consolidated return and elects instead under the provisions of section 223 of H.R. 8363 to allocate one surtax exemption among the members of the group, the group should be permitted to transfer capital freely among its members as in the case of a single corporation operating through divisions and as in the case of an affiliated group filing a consolidated return.

There are many sound business reasons why some affiliated groups of corporations would not wish to file a consolidated return:

1. Where there are minority interests in a subsidiary company (which can be as much as 20 percent), filing a consolidated return could result in damage to the minority through diversion of tax benefits of that particular subsidiary to other companies in the affiliated group.
2. Various members of the group may be using alternative, but acceptable, tax accounting methods, but if they participate in a consolidated return they will be able to continue to use those differing methods only if the Commissioner consents (regulations section 1.1502–44).
3. The various members of the group may also be using different taxable years to conform with the natural business years of the separate enterprises. If they join in a consolidated return, all of them will be required to adopt the year of the parent, which may present business problems and in some cases may be impossible.

None of these reasons justify different treatment for affiliated groups which fail to file a consolidated return.

Entertainment, travel, and gift expenses

Because of substantial difficulties of interpretation, application, and administration of section 274, major modifications should be adopted. The proposed amendment to H.R. 8363, introduced by Senator Long on October 15 (amendment No. 229), would accomplish the much needed revisions in a way which we support wholeheartedly.

The committee on Federal taxation is opposed to entertainment expense abuses, as it is opposed to any misuses of the tax law. However, while the prevention of such abuses is the main purpose of section 274 that is not its sole effect.

We are convinced that section 274, in its present state, has the effect of disallowing many entertainment expense deductions which are perfectly proper, are dictated by sound business judgment, and result from a desire to maintain good relations with present customers and to foster amicable relations with prospective customers. On the other hand, amendment No. 229 would have the

desired effect of ending abuses without interfering with legitimate deductions.

In reassessing problems in this area, there are several factors which should be considered in determining whether the suggested changes in section 274 are warranted:

A. *Reversal of Cohan rule appropriate.*—The statutory reversal of the *Cohan* rule was quite proper. Deductions are a matter of legislative grace, and it is not at all unreasonable to insist that taxpayers prove that an expense was incurred and that it fits the requirements of the section pursuant to which a deduction is sought.

B. *Improved administration effective.*—A large part of the 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 experience of our members in the past year or so has indicated that the stepped up activity of the Internal Revenue Service 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, has been substantially better and more successful than in prior years.

C. *Courts support Commissioner most of the time.*—There is evidence that the courts also have been increasingly more stringent in their travel and entertainment expense decisions. Instead of being taxpayer minded, the courts have supported the Commissioner of Internal Revenue most of the time. It is interesting to note, for example, that in *Challenge Manufacturing Co.*, 37 T.C. 650, involving depreciation and expenses of a yacht, the court upheld the Commissioner's allowance of about one-half of the expenses claimed, but indicated that it thought the Commissioner had been "exceedingly generous." Elimination of the *Cohan* rule would have made the Commissioner's victories even more sweeping.

D. *New rules operate unfairly.*—Admittedly, the decisions which had to be made by Congress in enacting section 274 were difficult ones and the attempt to provide the greatest equity among taxpayers while at the same time attempting to prevent abuses made for definitional problems. Nevertheless, the new rules contain many new conceptual tests which are extremely difficult to understand and apply. The following examples indicate the manner in which these rules operate in a way which we believe to be unfair and undesirable:

1. John Jones is the head of a family manufacturing concern. The wife of his best customer enjoys classical music, so once a year John and his wife take the customer and his wife to dinner and a concert. Dinner is at a fine restaurant which provides an orchestra for dancing. This is the only time during the year that this customer is entertained, and business is discussed only in passing. The cost of the tickets to the concert clearly are not deductible under section 274. Whether the dinner is deductible depends, in the language of the regulations, on whether the circumstances are "generally conducive to business discussion"; whether "the surroundings in which the food or beverages are furnished * * * provide an atmosphere where there are no substantial distractions to discussion"; or whether under the circumstances "there are major distractions not conducive to business discussion." An internal revenue agent examining Mr. Jones' return will have to measure the quantum of distraction attributable to the dance orchestra (whether or not the Jones' or their guests actually danced) in order to decide whether or not the "business meal" rule applies.

This illustration, it should be noted, relates to the whole question of goodwill entertaining which, it seems to us, is the most objectionable feature of section 274. Scores of similar cases drawn from actual experience could be cited. Furthermore, there is an open question as to how the courts will deal with this aspect of section 274. Why, for example, is goodwill "associated with" but not "directly related to" a business? Commentators are already raising questions as to whether the "directly related" test really is new or is merely a codification of judicial law. (See "1962 Act: Is the 'Directly Related' Test for Entertainment Really New?" Journal of Taxation, December 1962, p. 366.)

2. Frank Smith is a wholesale grocer and sells to many small customers in his home community. The only business entertaining he does during the year is at Christmas time when he rents a large room in a hotel and invites all of his customers and their wives to a buffet luncheon. A "walking" orchestra, which

circulates around the room, is the only entertainment provided. Frank's purpose for running the party is to create or maintain the goodwill of his customers. Business, if it is discussed at all, is only incidental. Although Frank might claim that his costs were "expenditures in clear business setting," regulations section 1,274–2(c)(4) probably may not support this claim and he might be unable to obtain a deduction for the Christmas party.

3. As a CPA, Tom Allen may not advertise for business. His community is on a large lake, and Tom has found it very useful to entertain clients and potential clients on a boat. Tom himself does not particularly like the water and, in fact, has a tendency to seasickness which he overcomes with pills. Nevertheless, he owns a boat and uses it practically every weekend to take out his business associates. He keeps a log and can prove that his family use comprises less than 10 percent of the total use of the boat. On the other hand, he does not maintain that any substantial business discussions take place—he concedes that his entertaining on the boat is of a goodwill nature, but it is of great importance to his business. None of the maintenance expenses of the boat are deductible. The deductibility of the food and beverages consumed would depend, once again, on an internal revenue agent's decision as to whether the fishing activities on the boat are "substantial distractions to discussion."

4. No portion of dues paid to a country club are deductible unless the club is used more than 50 percent for business purposes. Many small businessmen use their club for important business activities but are not able to meet the 50-percent test. Suppose, for example, a businessman would not join his club but for the opportunity to use it for business purposes. Because he belongs, however, his wife and family make substantial use of the club. The businessman himself does not use the facilities nearly as often, but when he does, the use is almost always business connected. Although the standards for measuring business use have yet to be perfected, it would appear likely that no portion of the dues are deductible.

E. *Treasury regulations long, complicated, and vague.*—We have indicated in the above examples a few of the problems which will be imposed on businessmen and internal revenue agents in applying section 274 and the related regulations. This is not intended as a criticism of the regulations. We believe, generally speaking, that the Treasury Department attempted to interpret the statute in a reasonable way. Indeed, in some respects, the regulations, particularly in the travel expense area, are quite liberal. The problems derive from the law itself.

Nevertheless, it must be noted that the regulations are very long, complicated, and in many areas vague and difficult to understand. They cover 32 pages in one of the standard tax services. They are broken into so many subsections, paragraphs, subparagraphs, divisions, and subdivisions that references such as regulations section 1.274–5(e)(2)(iii)(b) are not unusual. They are replete with passages such as: "In the light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control), etc."

We recognize that there are many complicated sections of the Internal Revenue Code and the Treasury regulations; however, complication should only be the result of real need. What is the justification for section 274? The purpose of section 274 is not to eliminate deductions for legitimate travel and entertaining expenses, but merely to eliminate abuses in this area. However, we believe our examples indicate that section 274 actually results in the disallowance of many readily defensible entertainment expense deductions. Is it really necessary, therefore, to prevent excesses? We think it is not.

It has been suggested that section 274 strengthens the tax structure and moral fiber of our society. Again, we disagree. In fact, resistance to overly harsh rules may have the opposite effect. There is nothing improper or immoral about legitimate entertainment and travel expenses. When based on good business judgment, they represent a reasonable attempt to increase revenue which in turn should increase taxable income.

We suggest that the continuation of section 274 in its present form is not in the best interests of our all-important self-assessment tax system. It is needlessly complicated, disallows deductions which should be allowed, and is not necessary to curb abuses. We respectfully urge that amendment No. 229 be enacted into law.

DEPRECIATION GUIDELINES

Amendment No. 319 to H.R. 8363, introduced by Senator Hartke for himself, and for Senators Randolph, McCarthy, and Javits, would establish regular use of the guideline lives prescribed in Revenue Procedure 62–21 for purposes of computing depreciation deductions. We recommend its enactment.

A. *Incentive effect of guideline lives would be fully realized.*—The proposed amendment, would direct the Secretary of the Treasury to issue regulations that describe classes of tangible property, prescribing a useful life with respect to each class not longer than the lives specified in Revenue Procedure 62–21 and the modifications thereof announced before September 30, 1963. These lives could then be used, at the option of a taxpayer, as his basis for computing depreciation deductions without regard to the practice of the taxpayer in replacing assets being depreciated. The effect of this provision would be to allow an election to taxpayers to compute depreciation according to guideline lives, but without the limitations of the reserve ratio test now contained in Revenue Procedure 62–21. The amendment also would provide that the assets be treated as fully depreciated at the end of a period equal to the life prescribed for assets of that class, thus resulting in a depreciation convention which would be simple and direct, but inflexible in its application. A similar concept of depreciation has been employed satisfactorily in Canada.

We heartily endorse the amendment as a practical and efficient way to permit taxpayers to avoid some of the intricacies of depreciation accounting for the sake of simplicity and still be in accord with Internal Revenue Service views as to useful lives.

It has been reported by the Commerce Department that only about 55 percent of industry adopted the guideline procedures in 1962. Whether the failure of a larger segment of industry to adopt guideline lives was the result of an unawareness of the benefits that are available in the guideline procedures, or whether there was considerable uncertainty about the future of guideline cannot be known. Certainly, some segments of American business must have declined acceptance of the guideline procedures because they could see only a brief respite from their depreciation problems. After the initial 3 years of the new procedures, the reserve ratio test inherent in Revenue Procedure 62–21 portended a sharp curtailment of its benefits.

B. *Reserve ratio test a determent.*—We believe that Revenue Procedure 62–21, as it now stands, does not offer an adequate incentive for investment in new industrial machinery in America. The shorter useful lives of Revenue Procedure 62–21 are only a palliative—not a real solution to the quest for an economic stimulant—for the incentive offered by the shorter guideline lives may be thwarted by the reserve ratio test included as a part of the guidelines procedure. The effect of the reserve ratio test is to permit only those useful lives that can be supported by the taxpayer's actual asset replacement experience. While it is acknowledged that Revenue Procedure 62–21 does permit a 3-year holiday before the reserve ratio test can be brought into play, if the reserve ratio test causes an adjustment in useful lives, the end result of its application will be to bring the taxpayer to the employment of useful lives which are no shorter than what is fully supportable by his own experience in replacement of assets. This is no more than taxpayers have always been entitled to under the depreciation provisions of the Internal Revenue Code. To give meaning to the guidelines procedure as an incentive to investment in industrial plant, taxpayers should be permitted a depreciation convention which embodies useful lives that are as short as the guideline lives of Revenue Procedure 62–21, but without the negative influence of the reserve ratio test.

The reserve ratio test is considered too complicated to be workable. Because of its complexity, the strict requirement of its use will pose a difficult problem of administration for the Internal Revenue Service. The elective treatment afforded by the proposed amendment, freeing the taxpayer from the involvements of the reserve ratio test, would be of mutual benefit to the taxpayer and to the Service. The amendment would provide a simple expedient and an administratively desirable way to eliminate arguments between taxpayers and representatives of the Service.

PART III. TECHNICAL COMMENTS ON SPECIFIC PROVISIONS OF H.R. 8363

SECTION 122. CURRENT TAX PAYMENTS BY CORPORATIONS

1. Proposed section 6655

Underestimation penalties.—The alternatives for avoiding underestimation penalties should be liberalized so that estimated tax based on the prior year's tax liability would qualify to avoid the penalty if 70 percent is paid instead of the present requirement of 100 percent.

The proposal for current tax payments by corporations increases the importance of the penalty provisions for failure to make required estimated tax payments.

Under present law, underestimation penalties are avoidable if the estimated tax payments fit any one of the following standards:

(1) they amount to 70 percent of the tax shown on the final return after subtracting $100,000 and allowing credits;

(2) they amount to as much as the previous year's tax reduced by $100,000;

(3) they are equal to what the previous year's tax (less $100,000 and allowable credits) would have been if current rates had been applicable to that year's income; or

(4) the installment with respect to the declaration for any quarter is equal to 70 percent of the tax (less $100,000 and allowable credits) due on the basis of the income received to date, placed on an annual basis.

The first and fourth standards are based on 70 percent of the tax liability for the current year, while the second and third are based on 100 percent of the previous year's tax liability. It is recommended that when the prior year's liability is used as the basis for the estimated tax computation, payments of 70 percent should qualify to avoid penalty as in the case of estimated tax computations based on the current year's tax liability.

The provision for annualization of the current year's income, contained in the fourth standard, requires that "taxable income" be computed for each short period. This presents substantial problems of computation and may be impractical because of the difficulty of reflecting such items as possible inventory adjustments for the year, profit-sharing and bonus amounts paid on an annual basis, and contributions to qualified profit-sharing and pensions funds normally determined toward the year end. The computation also requires an accurate determination of depreciation which otherwise might be estimated, and other adjustments, such as bad debt chargeoffs, which might normally be made only once a year.

2. H.R. 8363 section 122

Refunds of overpayments.—Provision should be made for prompt refunds of overpayment of estimated tax, both as tentative refunds during the taxable year and promptly after the close of the year.

Situations will arise where profits anticipated early in a taxable year will be dissipated by an unusual event, such as a casualty, strike, etc. Under these circumstances, future payments of estimated tax may be eliminated by an amended declaration. However, there is no provision for prompt refund of amounts previously paid. Prompt refund of excess payments may be so important in individual cases that it should be directly by statute, along the following lines:

1. Statutory requirement for the prompt refund of an overpayment of estimated tax shown by the return for the year, upon application by the taxpayer.

2. Refund prior to the end of the taxable year of amounts of tentative tax paid within that year, upon application by the taxpayer.

SECTION 202. INVESTMENT CREDIT

1. Proposed section 48(d)(2)

Lessee-lessor members of an affiliated group.—This provision should be clarified to indicate that a nonmember sublessee from a member of an affiliated group of leasing companies may use fair market value to compute its investment credit.

The amendment to existing section 48(d)(2) should be clarified to indicate that a lessee from another member of an affiliated group will compute the investment credit based on the lessor's basis only if the lessee company itself claims

the investment credit. If the lessee company in turn leases the property to an unaffiliated user and elects to pass on the investment credit, the unaffiliated user should be entitled to compute the investment credit on the fair market value of the property.

This clarification is necessary to insure that an affiliated leasing company is not placed at a competitive disadvantage to unaffiliated leasing companies where the two may be leasing the same items.

2. H.R. 8363, section 202(a)(4)

Effective dates—Repeal of basis adjustment.—Repeal of the basis adjustment should be made effective with respect to property placed in service in years ending after enactment, and the restoration of basis to property to which the basis adjustment was previously applied should be effective as of the beginning of the first taxable year ending after enactment.

In the case of property placed in service after June 30, 1963, the repeal of the basis adjustment would apply to taxable years ending after that date; for property placed in service before July 1, 1963, the repeal would apply to taxable years beginning after June 30, 1963. Furthermore, the increase in basis provided for pre-July 1, 1963 property is to be made, pursuant to proposed section 202(a)(2)(C), as of the first day of the first taxable year which begins after June 30, 1963.

The proposed effective dates seem to postpone unnecessarily the repeal of the basis adjustment provision. They also would result in forcing certain taxpayers to effect the basis adjustment, and compute depreciation accordingly, with respect to assets acquired prior to July 1, 1963, even though such taxpayers know at the time that the basis adjustment will be restored in the following year. In addition, the June 30, 1963, date assumes passage of the bill in sufficient time for certain fiscal year taxpayers to apply the provisions with respect to property acquired on or after July 1, 1963.

It would appear simpler to make the provisions of proposed section 202(a) applicable to property placed in service in taxable years ending after date of enactment, and to make the restoration of basis to property placed in service in prior years effective as of the beginning of each taxpayer's taxable year ending after date of enactment. The latter procedure would satisfy the intent expressed on page 37 of the House committee report, as follows:

"This method of handling the restoration of the basis in the case of previously acquired investment credit assets makes the taxpayer 'whole' without the necessity of refunds."

3. H.R. 8363, section 202(a)(2)(B)

Restoration of basis adjustment—Leased property.—Adjustment of previously disallowed rent should be in full in the taxable year in which the basis adjustment provided in proposed section 202(a)(2)(C) is made.

In the case of leased property with respect to which the lessee has received the credit, proposed section 202(a)(2)(B) would provide an adjustment of previously disallowed rent "under regulations prescribed by the Secretary of the Treasury or his delegate * * * in a manner consistent with subparagraph (A)." The House committee report, at page A25, indicates that the adjustment should be "taken into account, commencing with the first taxable year beginning after June 30, 1963, over the remaining portion of the useful life used in making the decreases in rental deductions with respect to such property."

This provision appears to prolong unduly the necessity of making what in many instances may be a comparatively minor monthly adjustment. Since the adjustments required by present law to the rental deductions of lessees have only been in effect with respect to property leased after January 1, 1962, it would appear feasible to permit the full increase in rental deductions to be made in the same taxable year in which the basis adjustment provided in proposed section 202(a)(2)(C) is made.

4. H.R. 8363, section 202(c) and (d)

Effective date—Elevators and escalators.—This provision should be retroactive to the effective date of the 1962 act provision rather than July 1, 1963, since its purpose is to include a class of assets originally intended for inclusion in the 1962 act.

The proposed effective date for qualifying elevators and escalators for the investment credit seems inequitable, particularly in view of the language in the House committee report indicating that elevators and escalators are closely akin

to assets "accessory to the operation" of a business which are presently eligible for the investment credit. Under the proposed effective date, elevators and escalators completed or acquired before July 1, 1963, would not be eligible. It is suggested that the inclusion of elevators and escalators in the eligible asset category should be given effect retroactive to the enactment of the investment credit.

SECTION 203. GROUP TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES

1. Proposed section 79(a)(1)

Group term life insurance up to twice an employee's annual compensation should not be taxed.—The arbitrary limitation of $30,000 should be amended to exempt the greater of $30,000 or twice the annual compensation of the affected employee.

A fixed ceiling on the amount of tax-free insurance coverage which may be provided employees would discriminate against employees at executive levels. Any restrictions should be on a basis that is not unreasonable and inequitable.

Many employers commonly provide employees with group term life insurance in an amount equal to twice the employer's annual compensation and some provide even greater multiples. In view of the common practice of providing employees with some multiple of compensation, we suggest that section 203 be amended to exempt the greater of $30,000 or twice the annual compensation of an employee.

2. Proposed sections 79(c)

An average method of computing the cost of insurance should be provided.—The proposed method of taxation of employee's group insurance benefits should be amended to provide a third alternative method of computing premium costs, i.e., an average method similar to the one presently used in Canada.

A third alternative method of computing cost should be provided since the proposed methods would be difficult and costly for employers to apply and could result in imputing taxable income to participants in a plan paid for solely by employees without employer contributions.

It would be difficult if not impossible for employers to apply the policy cost method on a payroll period basis. In addition, payroll computation would be made more complex as a result of the proposal. They would require dealing with additional factors, such as an employee's age and insurance coverage, which are otherwise not involved in payroll computations. The additional expenses, which could be substantial, would be fully deductible and would serve to reduce the $5 million in revenues anticipated from the measure.

Adoption of the age bracket method in the provision is arbitrary in that it takes into account only one premium determining factor, albeit an important one, ignoring many others, such as the health of employees, etc.

It would seem that these difficulties could be obviated by adopting the simple method of calculating the cost of insurance in excess of $30,000 on the basis of the average premium cost to the employer per each thousand dollars of insurance coverage provided for all employees. This would enable employers to use a single rate for all employees in calculating the cost of insurance coverage instead of requiring a different rate for each age bracket. This method of calculation of cost is used in Canada and appears to be operating satisfactorily. Adoption of the average method need not change the amount of coverage exempted and would have the advantage of reducing the employer's administrative expense. Also, it would preclude imputation of income in a plan where the premiums are paid entirely by employee contributions.

SECTION 204. EXCESS MEDICAL EXPENSE RECOVERY

Proposed section 80

Includible excess medical expense recovery should not be net of premium cost.—Accident and health insurance premiums paid should be considered in determining the amount of the excess medical expense recovery included in gross income under this provision.

This provision would tax the "economic benefit" resulting from duplicate medical payment recoveries which escape taxation under present law. This is to be accomplished by including in income the excess of such recoveries over applicable medical expenses, as defined in section 213(c): Health and accident

insurance premiums, however, are excluded from the definition of "medical expenses" for purposes of computing the excess which is to become taxable under the proposal. (The proposal does not affect the present status of health and accident insurance premiums which would continue to qualify for deduction as medical expenses under sec. 213, but which may not result in deductions because of the limitations of that section.)

It is inconsistent with the concept of income as used in our tax system to impose a tax on a gain without allowing a deduction for the cost of securing the gain. In this case the premium gives rise to the income received, and should be deductible as a cost thereof.

We recommend that taxpayers be permitted to include premium costs in the computation to determine the excess medical expense recovery which is to be taxed under this proposal. To the extent premiums are offset in this manner, they would be considered reimbursed medical expenses and therefore, not deductible as medical expenses under section 213. This recommendation should of course be restricted to preclude the possibility of a double deduction of such premiums in case of multiple recoveries under a single policy in a given year.

It should also be noted that in view of the Ways and Means Committee's finding that proposed section 80 would produce negligible revenues, adoption of this recommendation in the interest of fairness would not materially reduce revenues projected from this measure. Furthermore, the additional complexity occasioned by modification of the definition of medical expenses (excluding health and accident insurance premiums from the definition of medical expenses for this purpose only) is not justified by revenue considerations nor principles of equity.

SECTION 207. DENIAL OF DEDUCTIONS FOR CERTAIN STATE, LOCAL, AND FOREIGN TAXES

Proposed section 164(b)

Definitions—Deductible taxes.—The terms used to define taxes which will be deductible under the proposed provision should be defined more precisely in order to prevent esrious administrative problems.

The proposal, intended to foreclose deductions for several classes of State, local, and foreign taxes, is presented in terms and format which represent a major departure from present law. Present section 164, substantially unchanged from the corresponding provision of the 1939 code, makes all taxes deductible, with certain enumerated exceptions. Proposed section 164(b) would enumerate four classes of deductible taxes, all others being disallowed.

It is recommended that the present structure of section 164 be retained, with the addition of further exceptions in section 164(b) designed to disallow the State and local taxes which Congress intends to be nondeductible. This would avoid the confusion that may result from the present proposal.

An alternative approach would be to make the definitions in proposed section 164(b) more precise. Some of the more obvious deficiencies in the definitions as now drafted are as follows:

Income taxes: The phrase "income taxes, etc." is not defined at all. It is not clear if it includes taxes on gross income. such as the Indiana gross income tax.

Personal property tax: As part of its personal property tax system, the State of Ohio taxes nonproductive stocks and bonds at their value. This tax would unquestionably qualify as a deductible ad valorem property tax; however, securities paying dividends or interest are taxed at the rate of 5 percent of their annual income yield in lieu of a tax based on their value. Although this tax is measured by income, it is a property tax. It is not clear whether this tax is deductible under proposed section 164.

General sales tax: On page A42 of the House committee report, it is stated that rentals qualify as sales at retail for purposes of deducting taxes thereon, if so treated under applicable State sales tax law. On page A43, an example is given which indicates that the District of Columbia 4-percent tax on transient accommodations is not deductible, but the 3-percent tax on tangible personal property is deductible. This kind of fine distinction is incomprehensible to the ordinary taxpayer. The purpose of the example is to illustrate the difference in treatment of a general sales tax which would be deductible and an excise tax which would not.

It would appear that the intended purpose probably could be accomplished better by incorporating in the statute definitions of excluded excise taxes, or a list of items which are usually subject to excise taxes; e.g., tobacco, alcohol, firearms, and public accommodations.

SECTION 212. MOVING EXPENSES

Proposed section 217

Proposed deduction should be broadened.—The proposed deduction should be expanded to encompass other expenses of relocating in addition to the basic costs of transporting the employee's household and his family.

Proposed section 217 would allow a deduction for employees' moving expenses, but would limit the deduction to the following specific costs:

1. Moving household goods and personal effects;
2. Transporttion of the employee and his family; and
3. Meals and lodging while in transit.

There are a number of other expenses usually incurred in the course of relocating, which in many cases may impose a more serious economic burden on the employee than those that would be allowed in the proposal. The additional expenses, which should be deductible along with the enumerated items include the cost of an advance trip to the new locality to search for living quarters, and living expenses incurred during a reasonable period at the new location while housing accommodations are secured. At the very least, either a deduction for a "scouting" trip, or temporary living expenses, should be allowed since the problem of finding living quarters is ever present in relocation situations.

Also, the out-of-pocket costs of acquiring and disposing of residental properties, terminating leases, etc., are normally incurred in the course of relocation, and should be deductible in accordance with the intent of the proposal.

SECTION 216. PERSONAL HOLDING COMPANIES

1. Proposed section 542(c)(6)

Percentage limitations.—The percentage limitations are inconsistent and their interaction can result in inadvertent loss of exemption without violation of the purpose of this provision.

Proposed sections 542(c)(6) (A) and (B) seem inconsistent from a practical point of view. Subparagraph (A) requires that at least 60 percent of ordinary gross income be from operations; subparagraph (B) requires that other types of personal holding company income plus certain interest be not more than 20 percent of ordinary gross income. It would seem that for most finance companies almost all of the nonoperating income would be from sources included in (B) thus, effectively, the operating income must be at least 80 percent of ordinary gross income for most companies rather than the 60 percent stated in subparagraph (A).

There is the further requirement in subparagraph (C) that the operating deductions must meet certain minimums. The combination of the three requirements in subparagraphs (A), (B), and (C) will greatly increase the danger of a corporation inadvertently becoming a personal holding company through some unavoidable change in income or deductions.

2. Proposed section 542(d)(1)(B)

Definition of "lending or financial business."—The definition of finance company, which is restricted to those making loans or discounts having a remaining life of 60 months or less, is unwarranted and will adversely affect many legitimate finance companies.

The House committee report (p. 81) indicates that proposed section 216 substitutes one definition of a lending or finance company for the four definitions presently in the code, and that the proposed substitution is "in the interest of simplification." Under proposed section 542(d)(1)(B), the term "lending or finance business," is not to include the business of "* * * making loans, or purchasing, or discounting accounts receivable, notes, or installment obligations, if (at the time of the loan, purchase, or discount) the remaining maturity exceeds 60 months * * *."

No reason is given in the House committee report for the 60-month limitation. No such limitation appears in the present law concerning gross income derived from purchasing, or discounting accounts, or notes receivable, or installment obligations. There is at least one industry—namely, the mobile home industry—in which present general practice is to provide 7-year financing.

There seems no reason to have any limitation upon the maturity of qualifying notes or installment obligations for purposes of defining a lending or financial business.

3. Proposed section 543(b)

Treatment of rents and royalties.—The new 10-percent test (providing that a corporation with income from rents and royalties may avoid classification of such income as personal holding company income only if its total personal holding company income from the sources other than the one being tested does not exceed 10 percent) should not be imposed on top of the existing 50-percent test which is to be retained under the proposal.

In addition to the change to a net income concept in the application of percentage tests in the case of rents and mineral, oil, and gas, and copyright royalties, a new factor is introduced into the determination of whether income from these sources will constitute personal holding company income. In general, such income is not treated as personal holding company income if it exceeds 50 percent of "adjusted ordinary gross income" ("ordinary gross income" in the case of copyright royalties). The new factor contained in the bill results in disregarding the 50-percent test if personal holding company income, including income from these sources other than income from the one being tested, constitutes more than 10 percent of the corporation's ordinary gross income.

This extraneous test unnecessarily complicates the personal holding company provisions and will produce such harsh results that it should be eliminated. It is obvious that the extent to which the corporation has other passive-type income and income from any one of the three noted sources are entirely unrelated factors. If it is desirable to restrict more severely the extent to which income from rents and royalties may be used to shelter other types of income, it would be more appropriate to increase the required percentage of income test above 50 percent or to lower the overall personal holding company income percentage requirement. The different combinations of income that are possible and the different percentage relationships of the various types of income to each other defy imagination. As a result, the consequences of this provision are impossible to predict.

We urge that this type of test or condition not be expanded beyond the instances in which it is currently used in the code.

4. Proposed section 543(b)(2)(C)

Exclusion of nonpassive interest.—Interest described in the House committee report as "nonpassive" should be considered part of "adjusted ordinary gross income" for purposes of applying the percentage test to determine if a corporation is a personal holding company.

In determining the percentage of "adjusted ordinary gross income" which consists of personal holding company income, interest on U.S. obligations of a dealer in such obligations and interest on a condemnation award, a judgment, and a tax refund are excluded from both the numerator and denominator of the fraction. In effect, such interest is thus excluded from consideration in determining this critical percentage.

The House committee report (p. 77) explains the exclusion by stating that this type of interest "in reality is not passive in nature." That being the case, we recommend that such interest in fact be treated as nonpersonal holding company income for this purpose. Thus, it should be excluded only from personal holding company income (the numerator of the fraction) but not from "adjusted ordinary gross income" (the denominator of the fraction) for the purpose of testing whether the corporation's passive income is sufficient in amount to make the personal holding company provisions applicable.

Ignoring such interest entirely (excluding it from both the numerator and denominator) as proposed, would normally result in a percentage somewhat lower than if such interest were considered personal holding company income (i.e., including such interest in both the numerator and the denominator). The "nonpassive interest" described in the House committee report should be treated in the same manner as other nonpersonal holding company income; that is, included only in the denominator. Such treatment would result in an even lower percentage.

5. Proposed sections 316(b)(2)(B) and 562(b)(2)

Income in year of liquidation.—The proposal, intended to tax individual shareholders at ordinary rates on personal holding company income not subjected to the penalty tax in the hands of the personal holding company in its year of liquidation, should be extended to include corporations.

The purpose of the proposal is, primarily, to change a situation under current tax law in which the income of a personal holding company for the year of its

liquidation is not subject to the penalty tax at the corporate level, and is taxed as a capital gain upon distribution to its stockholders, both corporate and noncorporate. The means adopted in this proposal is to make sure that, with respect to noncorporate shareholders only, the personal holding company tax is avoided only if such shareholders include oridinary dividend income. Corporate shareholders, on the other hand, still would include capital gain as under existing law, and would be denied the privilege of the dividends received deduction.

The effect of the proposed partial withdrawal of capital gain treatment is to change the law in situations in which the tax is increased as a result of the change, but to retain the treatment of present law where maintaining the status quo results in greater tax. We do not believe this to be fair, and recommend that corporate shareholders of personal holding companies be granted similar dividend treatment (except in cases of the tax-free liquidation of subsidiaries). It should be noted that this suggestion may create personal holding company problems for corporate recipients which they might not otherwise have under the new law in which all capital gains are excluded from both the numerator and denominator of the personal holding company income determining fraction.

6. Proposed section 333(g)

One-month liquidations.—There is no apparent purpose for denying proposed class A capital gain status to a section 333 liquidation of a personal holding company; in fact, it is inconsistent with the intent of the proposed amendment to section 333.

The proposed amendments grant capital-gain treatment in a section 333 liquidation to certain earnings and profits of a corporation affected by the new personal holding company definitions instead of the dividend treatment required under present law. Regardless of the length of time the personal holding company stock has been held, such capital gain will be treated as proposed class B capital gain. Since the gain on the liquidation of a corporation under section 331 may qualify for proposed class A treatment, although a portion (or all) of such gain is attributed to the corporation's accumulated earnings and profits, we do not see why gains attributed to earnings and profits in the situations covered by proposed section 333(g) may not similarly qualify.

It should be noted further that the purpose of altering the usual section 333 rules in the stated circumstances is to grant relief to corporations which will become personal holding companies because of the bill. Granting proposed class A treatment is more consistent with that purpose than is the denial of such treatment.

SECTION 219. CAPITAL GAINS AND LOSSES

Proposed section 1212(a)

Unlimited capital loss carryover for corporations.—The unlimited capital loss carryover privilege should be extended to corporations.

There appears to be no basis for confining the unlimited capital loss carryover privilege to individuals. The House committee report (p. 96) explains the reason for the provision as follows:

"Similarly, the indefinite extension of the capital loss carryover is intended to increase the volume of funds available for investment in new and risky enterprises. By giving greater assurance that any capital loss incurred from a venture eventually can be offset against income otherwise taxable, the risk in such ventures is decreased, thereby making such investment relatively more attractive."

These reasons are equally valid for corporations. No reason for their exclusion is given in the House committee report.

SECTION 220. DISPOSITIONS OF DEPRECIABLE REAL ESTATE

1. Proposed section 1250

Allocations between land and improvements.—Allocations of selling price between land and improvements should be afforded a statutory rebuttable presumption of correctness to limit the controversy which would result from indiscriminate reallocations by the Internal Revenue Service.

In the case of sales of improved real estate, allocations of selling price between land and improvements made in the contract of sale should be given a rebuttable presumption of correctness. This provision would tend to foreclose

the endless controversy between the Commissioner and the taxpayer which might result from inherent allocation disputes.

Since the buyer and seller are adverse parties and presumably would have opposite aims, it seems likely that the allocation between land and improvements would be determined fairly and at arms length. The Commissioner would of course be able to overcome the presumption in appropriate cases.

SECTION 221, INCOME AVERAGING

1. Proposed sections 1302(a)(2) and 1304(e)(1)(A)

Capital gains.—Long-term capital gains are properly excluded from the benefits of averaging; however, taxpayers reporting capital gains are otherwise subject to discrimination under the proposed averaging provisions.

(*a*) The floor to which averageable income is added includes average base period capital gain net income, thus increasing the bracket at which the averageable income will be taxed. This rule applies even if the long-term gains during the base period were subjected to the alternative tax. It seems unfair to use prior capital gains to increase the tax on averageable income, while at the same time excluding current capital gains (even though not subject to the alternative tax) from the averaging privilege. This inequity should be remedied by consistently including or excluding capital gains in the computations. We believe they should be completely excluded.

(*b*) Averageable income for the current year must be reduced by the amount by which the average base period capital gain exceeds the capital gain for the computation year. The House committee report (p. 113) states:

"Generally, it was thought that capital gains should be set apart and not taken into account in averaging since they, in effect, have their own specialized form of averaging. However, in those cases where the average capital gains in the base period exceed the capital gains in the computation year, it is believed that averaging should be permitted only when total taxable income of the current year is substantially greater than the average of the base period."

Here again, it appears to be unfair and inconsistent to use long-term capital gains to reduce the benefits of averaging ordinary income. We believe, as stated in item (*a*) above, that long-term gains should be excluded from all of the averaging provisions. Proposed section 1302(a)(2) should, therefore, be eliminated.

(*c*) In determining the tax payable in the computation year on the net long-term capital gains of a taxpayer electing to average, complicated rules apply. The primary significance of these rules appears to be in determining whether the alternative tax applies and, if so, how much the tax liability is reduced as a result thereof.

The effect of proposed section 1304(e)(1)(A) is that the portion of the long-term capital gains of the current year which does not exceed the average base period capital gain is considered as being taxed right above the income equal to 133⅓ percent of the average base period income. Only the excess of current over average long-term gains is treated as being taxed at the top bracket. This treatment is different from the usual alternative tax computation in which, in effect, includible long-term gains are all considered as being taxed at the top of all of the taxpayer's income. There appears to be no reason why these regular rules should not be equally applicable when averaging is elected, and proposed section 1304(e)(1)(A) should be amended accordingly.

2. Proposed section 1302(b)(2)

Income attributed to gift property.—The proposed 6-percent rate of income attributation is unrealistic and inconsistent with other provisions of the code.

This provision establishes a rebuttable presumption that certain property received as a gift or bequest earns income at the rate of 6 percent per annum. The presumption is unrealistic and inconsistent with the actuarial tables used for gift and estate tax purposes, which use an assumed rate of income of 3½ percent. That rate should be substituted for the 6-percent rate proposed.

3. Proposed section 1302(b)(3)

Wagering income.—Wagering income is excluded from averageable income in the computation year. We question the purpose of this provision, and recommend that if it is retained, it be restricted to income from illegal gambling, and that to the extent retained, such income should also be excluded from average base period income.

We question the propriety of using the Internal Revenue Code to effect a measure of social policy by excluding gambling income from the benefits of averaging. If wagering income (which should be defined) must be singled out for less favored treatment, we believe the policy objective could be as well served if only wagering income from illegal gambling were excluded from the benefits of the proposal.

Furthermore, if wagering income must be deducted from averageable income in the current year, equity requires an offsetting deduction of similar wagering income included in the average base period income, at least to the extent of the amount of such income denied the benefit of averaging in the current year.

4. Proposed section 1302(c) (2) (A)

Treatment of earned income from foreign and U.S. possessions sources in computing base period income.—Based period income is properly increased by the amount of exempt income from foreign and U.S. possessions sources to avoid a windfall in the year such exemption terminates. However, this provision penalizes unfairly a taxpayer whose exemption status does not change.

Base period income must be increased by foreign source income exempt under section 911 and U.S. possessions source income exempt under section 931 and following. This is explained in the House committee report (p. 112) as follows:

"The inclusion of such income amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging."

A question arises if the taxpayer is still a foreign resident in the computation year, but receives a windfall that is subject to tax. If proposed sections 1304 (b) (3) and (4) are deleted, as we propose (see item 5 below), the effect of this provision would be to decrease the averageable windfall by the base period exempt foreign income. Even if proposed sections 1304(b) (3) and (4) are retained, any amount by which the average base period foreign income exceeds the equivalent income in the computation year would adversely affect the windfall averaging. (It should be noted that the 133⅓-percent multiplicand applied to the average base period income accentuates the problem.) Neither of these results appears to be warranted by the purpose of proposed section 1302(c) (2) (A) as expressed in the House committee report. This section should, therefore, be amended to insure that it will apply only to the situation presented in the House committee report.

5. Proposed sections 1304(b) (3) and (4)

Treatment of earned income from foreign and U.S. possessions sources in computation year.—The exemption of income from foreign and U.S. possessions sources must be waived by a taxpayer electing the benefits of averaging. These provisions appear unduly harsh and discriminating, and should not be enacted.

In order to qualify for averaging relief, a taxpayer must give up his tax exemptions for earned foreign income under section 911 and for income from sources within U.S. possessions under section 931 and following. No other types of tax-exempt income are so treated, and we fail to see why exempt foreign and U.S. possessions income (already materially reduced by the Revenue Act of 1962) should be so discriminated against.

We recommend elimination of this requirement in conjunction with the previous recommendation for elimination of the requirement of inclusion of such income in base period income. (See item 4 above.)

SECTION 222. REPEAL OF ADDITIONAL 2-PERCENT TAX FOR CORPORATIONS FILING CONSOLIDATED RETURNS

H.R. 8363, section 222

Intercompany profits in inventories.—A stated purpose of section 222 of the bill (House committee report, p. 116) is to encourage the filing of consolidated returns. In accordance with this objective, and in furtherance of equitable treatment, a statutory modification of the treatment of adjustments resulting from elimination of intercompany profits and losses in inventories is recommended. Present provisions of the consolidated return regulations require the elimination of intercompany profits and losses in inventories at the beginning of the first consolidated return year following separate returns. Thus elimina-

tion of intercompany profits result in double taxation at that point which may possibly, but not necessarily, be recovered in the first separate return year following a consolidated return year. The Internal Revenue Code should be amended to provide for the elimination of intercompany profits and losses in inventories at the beginning of the first consolidated return year following separate returns of members of the same affiliated group, as the regulations presently provide, but then in that first consolidated return year, and in each of the following 4 years, one-fifth of the amount of such adjustments should be treated as an adjustment in determining consolidated taxable net income.

Regulations section 1.1502-39 provides that if the members of an affiliated group file separate returns for the year immediately preceding the filing of a consolidated return, the opening inventories of that first consolidated return period must be decreased by the amounts of profits or increased in the amounts of losses reflected in such inventories which arose in transactions between members of the affiliated group and which have not been realized by the group through final transactions with persons other than members. Then, if for a later year the members of the affiliated group again file separate returns, the value of each company's opening inventory to be used in that first succeeding separate return year shall be the proper value of its closing inventory used in computing consolidated taxable income for the last consolidated return period, increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group. However, the increase or decrease, as the case may be, is not to exceed (1) the similar amount reflected in the closing inventory of that first succeeding separate return year or (2) the similar amount eliminated from its opening inventory for the preceding first consolidated return period which immediately followed a preceding separate return. For example, assume that a parent corporation and its wholly owned subsidiary corporation filed separate returns for the calendar year 1963, then filed a consolidated return for 1964, and changed back to separate returns in 1965. The intercompany profit in the subsidiary company's inventory is as follows:

Dec. 31—	
1963	$100,000
1964	80,000
1965	75,000

In determining consolidated taxable net income for the calendar year 1964, $100,000 of intercompany profits in inventory existing at January 1, 1964, is eliminated despite the fact that tax was paid upon it for the calendar year 1963. Then for 1965, in determining the separate return taxable income of the subsidiary, only $75,000 is added to the opening inventory. This means that over a 3-year span $25,000 out of the $100,000 adjustment at the beginning of 1964 has been taxed twice.

There are instances in which this opening adjustment will never be recouped even partially as in this example. If the subsidiary were liquidated into the parent during a consolidated return year, there would never be any recovery of the double taxation. Similarly again, if in a later consolidated return year the parent sells the stock in that subsidiary so that it no longer remains an affiliate, the intercompany profit in inventories at the end of the first succeeding separate return year will undoubtedly be zero so that no part of the double taxation will ever be recovered.

Equity dictates that there should never be any double taxation. It is proposed that the Internal Revenue Code be amended to provide that the adjustment to opening inventories in a first consolidated return period following a separate return year continue to be made as prescribed by the present regulations, but then that an adjustment be made in determining consolidated taxable net income of that first consolidated return year and in each of the 4 succeeding years for one-fifth of the amount of such inter-company profits or losses in inventories which were eliminated.

If in a succeeding year separate returns are again filed, any unamortized portion of the deferred adjustment should follow the company whose inventories were adjusted. There would then be no need for regulations section 1.1502-39(c) providing for a total or partial or zero restoration of the adjustment at the beginning of the first separate return year following a consolidated return year.

SECTION 223. REDUCTION OF SURTAX EXEMPTION IN CASE OF CERTAIN CONTROLLED CORPORATIONS

1. Proposed section 1562

Annual election should be provided.—An annual election should be provided for the multiple surtax exemptions. It would be consistent with the purpose of the proposal and would eliminate many of the complexities and potential hardships.

Much of the complexity in section 223 of the bill stems from proposed section 1562 which provides for the multiple surtax exemption election. This election, once made (and it can be made retroactively for 3 years), is binding upon the members of the controlled group for all subsequent years. The election can be terminated, but it is in the termination rules that much of the complexity lies. It is here also that the Treasury is authorized to issue regulations determining "when a controlled group is terminated," and defining a "successor controlled group."

It would be much simpler to give a controlled group of corporations an annual election to adopt one of the three alternatives, as follows:

1. Apportion a single surtax exemption among the members of the group.
2. Elect multiple surtax exemptions and pay the additional tax imposed.
3. File a consolidated return, assuming the group is eligible.

The general reasons for section 223 are expressed on pages 117 and 118 of the House committee report as follows:

1. The substantial tax reduction on the first $25,000 of income should not provide added inducement to split into multiple corporations. Therefore, the benefits of the tax reduction are limited in cases of a controlled group.
2. Groups which do not choose to file consolidated returns are to be left in approximately the same relative position as under present law.

Within these general objectives, it should be possible to give each controlled group an annual election to adopt one of the three methods prescribed. There seems no detriment to the revenue from allowing each group to elect each year.

2. Proposed section 1562 (b) (1)

Additional tax imposed should be limited to tax savings achieved through multiple surtax exemptions.—The additional tax imposed on any corporate member of a controlled group should be limited to the tax savings resulting from the use of surtax exemptions by the other members of the controlled group.

The additional tax is not applicable to a corporation if no other members of the controlled group have taxable income in the particular year. If, however, one other member of the group should have $100 of taxable income, then the additional tax could be $1,500 on the first corporation.

Since the purpose of the legislation is to prevent excessive savings from multiple surtax exemptions, it seems equitable to limit the additional tax to savings which are actually being realized.

3. Proposed section 1563(e) (5)

Status of community property stock is unclear with respect to "direct ownership".—The status of stock which is community property should be made clear for purposes of the direct ownership rule.

Questions will arise as to the operation of the direct ownership rule where there is stock owned as community property. For instance, a wife is not deemed to own the stock in corporation A owned by her husband unless she also owns stock in corporation A "directly." If the stock in corporation A owned by her husband was acquired from community funds, does this mean that the wife has a "direct" stock ownership in corporation A?

SECTION 302. INCOME TAX COLLECTED AT SOURCE

1. Proposed section 3402(a)

Withholding tax rate should be modified to allow for standard deduction.—The present withholding rate is 90 percent of the basic tax rate, allowing for a standard deduction of 10 percent. The corresponding provisions of H.R. 8363, which calls for a withholding rate equal to the basic tax rate in 1964, should be revised to allow for the standard deduction.

Under the present withholding provisions, the withholding rate is 18 percent of taxable wages as compared with the basic tax rate of 20 percent. The difference of 10 percent of the basic rate allows for the 10-percent standard deduction. This difference in the withholding rate has been in the law since the enactment of the Current Tax Payments Act of 1944. Under the proposal, the basic tax rate drops to 16 percent for 1964 and the withholding rate drops

to 15 percent. After 1964 both the basic tax rate and the withholding rate will be 14 percent. No reason for ignoring the standard deduction is given in the House committee report.

2. Proposed section 3402(a)

Withholding table should give effect to minimum standard deductions.—The withholding table does not give effect to the new minimum standard deductions, with the result that many unnecessary refund situations will be created.

On page 25 of the House committee report it is stated that a single individual would have no tax until his annual income exceeded $900; however, the withholding table provides for withholding on a monthly salary of $56 or an annual total of $672.

The House committee report also stated that a married couple with four exemptions would pay no tax on the first $3,000 of income; however, withholding is provided on monthly compensation of $224 which is an annual total of $2,688. It is assumed that the other tables would produce similar results.

It would appear that these schedules should be revised so that there would be no withholding on compensation that will yield no tax.

PHILADELPHIA BAR ASSOCIATION,
COMMITTEE ON TAXATION,
Philadelphia, Pa., December 5, 1963.

Re Revenue Act of 1963 (H.R. 8363, 88th Cong., 1st sess.).

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Enclosed are five copies of the comments of the Committee on Taxation of the Philadelphia Bar Association on the Revenue Act of 1963 (H.R. 8363).

These comments are submitted in lieu of an appearance before the Committee on Finance. It is requested that they be made a part of the hearings on H.R. 8363.

Three of the comments relate to the basic problem of not introducing unwarranted complexity into the code. These are:

1. Bill section 216 (relating to personnel holding companies) as written unduly further complicates an already complicated and severe penal provision. Ten amendments are proposed if the section is not deleted.
2. Bill section 220 (relating to disposition of depreciable real property, introduces undue complexity when the small amount of revenue is considered. Five amendments are proposed if the section is not deleted.
3. The action of the House in continuing present law by permitting property to receive new basis at death without income tax is approved.

The committee on taxation shall be pleased upon request to forward additional copies of its comments.

Respectfully,

LEONARD SARNER, *Chairman.*

COMMITTEE ON TAXATION,
PHILADELPHIA BAR ASSOCIATION,
Philadelphia, Pa., December 5, 1963.

Re Revenue Act of 1963 (H.R. 8363, 88th Cong., 1st sess.).

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: The committee on taxation of the Philadelphia Bar Association submits herewith its comments and recommendations with regard to the above-proposed legislation:

QUESTION OF OVERSIGHT

Bill section 111 (IRC, sec. 1(c)): In its present form code section 1 imposes tax at progressive rates up to 91 percent, subject, however, to a provision in section 1(c) that "the tax shall in no event exceed 87 percent of the taxable income for the taxable year."

Bill section 111 would reduce the progressive rates under section 1 to a maximum rate of 77 percent for 1964 and 70 percent for subsequent years. It would not, however, amend section 1(c) in any respect, with the result that the maximum effective rate of 87 percent thereunder would remain in the code.

Comment: With the maximum bracket rate reduced from 91 to 77 percent and then 70 percent, the maximum effective rate could no longer have any possible meaning if left at 87 percent. While retaining the present provision in the code can cause no harm, it would seem preferable either to eliminate it, in order to avoid what will otherwise become a historical anomaly, or to reduce the maximum effective rate to a meaningful lower level.

An amendment to code section 1(c) along either of these lines would create no problem of transition in the case of high bracket fiscal year taxpayers since code section 21(a), dealing with rate changes, would make the existing 87-percent ceiling applicable in computing the tentative tax under section 21(a)(1).

Suggestion: The committee suggests that either code section 1(c) be repealed or that a new paragraph (c) be added to bill section 111 to provide for an amendment to code section 1(c) reducing the maximum effective rate of 87 percent to a meaningfully lower level.

QUESTION OF INCONSISTENT DRAFTSMANSHIP

Bill section 207(a) (IRC, sec. 164(a)):

"(a) GENERAL RULE.—Except as otherwise provided in this *section*, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued." [Emphasis added.]

Comment: Nothing in section 164(a), as amended, prohibits a deduction for foreign income and profits taxes. However, under proposed new section 275(a)(4) such taxes would, as in the past, be nondeductible if the taxpayer elects to take the foreign tax credit under section 901.

Suggestion: The introductory clause under section 164(a) should be revised to substitute for the word "section" the word "chapter."

QUESTION OF INCONSISTENCY

Bill section 207(a) (IRC, sec. 164(a)):

"(a) GENERAL RULE.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

"(1) State and local, and foreign, real property taxes.

"(2) State and local personal property taxes.

"(3) State and local, and foreign, income, war profits, and excess profits taxes.

"(4) State and local general sales taxes."

Comment: The House Ways and Means Committee report on the bill (general explanation pp. 47–51) cites two reasons for the limitation of deductible taxes to real and personal property taxes, income taxes and general sales and gross receipts taxes. These are as follows:

(1) For the most part other State and local taxes heretofore deductible are difficult to substantiate or to estimate with reasonable accuracy. On the other hand, State income taxes usually may be substantiated exactly, and sales taxes may be substantiated by reference to the Internal Revenue Service's sales tax deduction tables.

(2) Some of the other State and local taxes which would be disallowed, particularly those on alcohol and tobacco, are not always imposed upon the consumer so that discriminatory treatment of taxpayers in different States results.

The bill would deny a deduction for State or local realty transfer taxes. In Pennsylvania the State and almost all of the local political subdivisions impose realty transfer taxes aggregating 2 percent of the gross consideration on any sale of real estate. This tax is a significant burden on homeowners, particularly those who are obliged to move frequently because of employer requirements. Since the tax is payable by stamps attached to the conveyance and is also evidenced by the settlement sheet executed by the seller and buyer, there is no problem of substantiation. Apparently, 11 other States impose similar taxes on real estate transactions most of which appear to be payable by stamp and are customarily evidenced by settlement sheets or like documentation. Neither reason cited by the House committee would apply to denial of a deduction for transfer taxes of this sort.

The bill would also make nondeductible foreign sales and personal property taxes, while permitting deductions for State and local taxes of this nature, and for foreign income taxes (if not taken as a credit). Inasmuch as sales taxes appear to be a much more significant source of revenue than income taxes in many foreign countries, it seems anomalous to disallow a deduction for them while allowing a deduction, and indeed a credit in most cases, for foreign income taxes. Substantiation of a general foreign sales tax by the use of a bracket table should be no more difficult than in the case of a State sales tax.

Foreign personal property taxes, like similar domestic taxes, present no problem of substantiation. The failure to allow a deduction might create serious discrimination against U.S. citizens residing abroad.

The House committee report cites no reason for denial of a deduction for foreign sales or personal property taxes.

Suggestion: Section 164(a) should be amended to read as follows:

"(a) GENERAL RULE.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

"(1) State and local, and foreign, real property taxes.

"(2) State and local, and foreign, personal property taxes.

"(3) State and local, and foreign, income, war profits, and excess profits taxes.

"(4) State and local, and foreign, general sales taxes.

"(5) State and local, and foreign, taxes on the transfer of real or personal property."

QUESTION OF REDUNDANT OR UNNECESSARY PROVISIONS

Bill section 207 (a), (b)(3) (IRC, secs. 164(c), 275(a)): "SEC. 164 (c). DEDUCTION DENIED IN CASE OF CERTAIN TAXES.—No deduction shall be allowed for the following taxes:

"(1) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

"(2) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer."

* * * * * * *

"SEC. 275(a). GENERAL RULE.—No deduction shall be allowed for the following taxes:

"(1) Federal income taxes, including—

"(A) the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

"(B) the taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

"(C) the tax withheld at source on wages under section 3402, and corresponding provisions of prior revenue laws.

"(2) Federal war profits and excess profits taxes.

"(3) Estate, inheritance, legacy, succession, and gift taxes.

"(4) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

"(5) Taxes on real property, to the extent that section 164(d) requires such taxes to be treated as imposed on another taxpayer."

Comment: The committee questions whether there is any point in disallowing specific Federal taxes under section 275(a) if, as is the case, section 164 is to be amended to allow a deduction only for State, local, and foreign taxes rather than allowing a deduction for all taxes with certain specified exceptions as at present. The committee is of the opinion that the disallowance provisions under sections 164 (c)(1) and (c)(2) and 275(a)(4) of the bill, being limitations on the deductibility of taxes which otherwise would be deductible under section 164(a), should all be set forth in section 164(c) so that section 164 will be a self-sufficient section containing all provisions relating to the deductibility or nondeductibility of taxes. In the alternative, if as a matter of structure of the

code it is deemed preferable to include in part IX of subchapter A all provisions denying a deduction for specific items which are otherwise deductible under previous parts, the committee suggests that section 164(c) be eliminated and that section 275 specifically deny a deduction only for taxes assessed against local benefits increasing in value of the assessed property (now sec. 164(c)(1)), real property taxes to the extent treated as being imposed on another taxpayer (present secs. 164(c)(2) and 275(a)(5)), estate, inheritance, legacy, succession, and gift taxes (present sec. 275(a)(3)), and foreign income taxes to the extent taken as a credit (present sec. 275(a)(4)).

Suggestion: The committee suggests that either section 164(c) or section 275(a) be redrafted to read as follows, and that the other, together with corresponding cross references, be eliminated entirely:

"No deduction shall be allowed for the following taxes:

"(1) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

"(2) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

"(3) Estate, inheritance, legacy, succession, and gift taxes.

"(4) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer."

QUESTION OF UNEQUAL APPLICATION

Bill section 211 (IRC, secs, 214(b)(2)(B), 214(b)(3)(B)):

"(B) shall be reduced by the amount (if any) by which the adjusted gross income of the taxpayer and (his/her) spouse exceeds $4,500."

Comment: In the case of a working wife or a husband with an incapacitated wife, the deduction for child care expenses is reduced where the combined income of the husband and wife exceeds $4,500 and is not available where the income exceeds $5,100.

In the case of a widow or widower, the deduction for child care expenses is not dependent on the income of the taxpayer being below certain figures. The high income taxpayers as well as the low income taxpayers can secure the deduction. There is no justification for discrimination against married individuals who incur child care expenses when seeking additional income. This unequal treatment should be changed.

Suggestion: Subsections (2) and (3) of section 214(b) should be changed to read as follows:

"(2) WORKING WIVES.—In the case of a woman who is married, the deduction under subsection (a) shall not be allowed unless she files a joint return with her husband for the taxable year.

"(3) HUSBANDS WITH INCAPACITATED WIVES.—In the case of a husband whose wife is incapacitated, the deduction under subsection (2) shall not be allowed unless he files a joint return with his wife for the taxable year."

QUESTION OF IMPROPER LIMITATIONS

Bill section 214(a) (IRC, secs. 422(b)(1), 423(b)(2)):

"SEC. 422(b)(1). The option is granted pursuant to a plan * * * which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted."

* * * * * * *

"SEC. 423(b)(2). Such plan is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted."

Comment: The House Ways and Means Committee report (General Explanation, p. 65) states that "stockholder approval is required for stock option plans to give assurance that the benefits granted management in the case of these options is in accordance with the desires of the stockholders."

In the first place, the committee is of the opinion that any requirement of approval of a stock option plan is one within the proper sphere of State law, and not one for proper regulation by a taxing statute. By comparison, stockholder approval is not required for other "fringe" benefits granted to employees, the

most evident of which is participation in qualified pension, profit-sharing, and stock bonus plans.

Secondly, the committee believes that the corporation laws of most States prescribe requirements for the approval of stock option plans which in many cases may be at variance with the proposed requirement set forth in the above paragraphs.

Third, there exist specific instances in which both management and broad-based employee stock option plans have been approved by the shareholders pursuant to applicable State law but not in sufficient detail that such approval constitutes the approval of the "plan" contemplated by the above paragraphs.

Fourth, in some specific cases shareholder approval of a detailed plan (but not actual "adoption" of the plan) has been granted longer than 12 months prior to the actual adoption of the plan.

Suggestion: The committee suggests that the language quoted from paragraph (1) of section 422(b) and paragraph (2) of section 423(b) be deleted entirely.

QUESTION OF FAILURE TO ALLOW DEDUCTION TO EMPLOYER WHEN EMPLOYEE REALIZES GROSS INCOME

Bill section 214 (IRC sec. 422(c) (1)):

"(c) SPECIAL RULES.—

"(1) EXERCISE OF OPTION WHEN PRICE IS LESS THAN VALUE OF STOCK.—If a share of stock is transferred pursuant to the exercise by an individual of an option which fails to qualify as a qualified stock option under subsection (b) because there was a failure in an attempt made in good faith, to meet the requirement of subsection (b) (4), the requirement of subsection (b) (4) shall be considered to have been met, but there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income for the taxable year in which such option is exercised, an amount equal to the lesser of—

"(A) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

"(B) the difference between the option price and the fair market value of the share at the time of such exercise.

The basis of the share acquired shall be increased by an amount equal to the amount included in his gross income under this paragraph in the taxable year in which the exercise occurred."

Comment: Section 422(c) (1) provides for inclusion in income notwithstanding a bona fide attempt to equate the option price with fair market value upon exercise of the option if in fact the option price was less than the fair market value at the time of grant. There is no correlative provision giving the employer corporation a deduction for the amount to be added to the employee's gross income "as compensation" in the year of exercise of such an option. If an individual is to have income in the nature of compensation, then the employer corporation should be entitled to a deduction for a similar amount. A deduction is allowed by section 421(b) where income results from the failure of the employee to hold his shares for the required period, and also by section 421(f) (as interpreted in Reg. § 1.421-5(e)) of existing law. However, neither provision would reach the situation described in section 422(c) (1).

Suggestion: Section 422(c) should be amended to read as follows:

"(c) SPECIAL RULES.—

'(1) EXERCISE OF OPTION WHEN PRICE IS LESS THAN VALUE OF STOCK.—If a share of stock is transferred pursuant to the exercise by an individual of an option which fails to qualify as a qualified stock option under subsection (b) because there was a failure in an attempt made in good faith, to meet the requirement of subsection (b) (4), the requirement of subsection (b) (4) shall be considered to have been met, but there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income for the taxable year in which such option is exercised, and there shall be allowed to his employer corporation as a deduction, an amount equal to the lesser of—

"(A) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

"(B) the difference between the option price and the fair market value of the share at the time of such exercise.

The basis of the share acquired shall be increased by an amount equal to the amount included in his gross income under this paragraph in the taxable year in which the exercise occurred."

QUESTION OF INCONSISTENCY AND OVERLY STRICT COVERAGE REQUIREMENTS

Bill section 214(a) (IRC, secs. 423(a) (2), 423(b) (4):

"(a) (2) At all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, he [the holder] is an employee of the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies."

"(b) (4) Under the terms of the plan, options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by such corporation, except that there may be excluded—

"(A) employees who have been employed less than 2 years,

"(B) employees whose customary employment is 20 hours or less per week,

"(C) employees who (sic) customary employment is for not more than 5 months in any calendar year, and

"(D) officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees."

Comment: The bill appears inconsistent in that some part-time employees who cannot be excluded under the permissible classifications of section 423(b) (4) if the plan is to qualify, cannot individually satisfy the requirement of being "at all times" employed as required by section 423(a) (2). For example, is an employee who is customarily employed for a period of 9 months during each calendar year employed "at all times" within the meaning of section 423(a) (2)?

Furthermore, the committee is of the opinion that the coverage requirements of section 423 are overly strict. Since the objective is to avoid discriminatory treatment and to require broad coverage of what might be classed as "permanent" or "regular" employees, this should be accomplished by a simple requirement of inclusion of employees on basis of a classification which does not discriminate in favor of officers, shareholders, supervisory employees, or highly compensated employees.

Such an approach would also eliminate the inconsistency previously noted between the employment requirements of sections 423(b) (2) and 423(b) (4), and the problem of determining the "customary" employment of a part-time employee. Further, it would be consistent with long-established standards for qualification of employees pension, profit-sharing and stock-bonus plans and trusts.

In addition, the committee report should state that the Commissioner (or the district director) will be expected to issue, upon request, the same type of advance rulings (or determination letters) on nondiscriminatory classifications as are now being issued with respect to the qualification of pension, profit-sharing and stock-purchase plans.

Suggestion: Paragraph (4) of section 423(b) should be amended to read as follows:

"(4) Under the terms of the plan, options are to be granted to such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees or highly compensated employees."

In any event, section 423(a) (2) should be amended to read as follows:

"(2) On the date of granting of the option, he is an employee of the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies and the option is exercised by him not later than 3 months after the date he ceases to be an employee of such corporation."

As previously indicated, the committee report should indicate that the Commissioner is to grant rulings or determination letters in this area.

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QUESTION OF UNDUE COMPLEXITY

Bill section 216 (IRC, secs. 541–543, 553–554, 316(b), 331(b), 562(b), 333, 1022, 1016(a), etc.):

Comment: The proposed changes in the code sections relating to personal holding companies are extremely complicated and drastic. While the committee believes that there is merit in the approach to eliminate abuses in this "tax shelter" area, the amendments as written unduly further complicate an already complicated and severe penal provision. It is important that any statute imposing such a tax be stated in language sufficiently simple and clear to be understandable by the average lawyer. Far from meeting this standard, it is most difficult for even the sophisticated tax practitioner to understand and apply the amendments which would be made by this section.

Suggestion: It is the committee's opinion that the personal holding company provisions be simplified and not further complicated. Accordingly, the committee opposes the changes provided for in section 216 of the bill, without, however, opposing the elimination of pure tax shelters.

Some of the provisions of section 216 which the committee finds particularly objectionable, confusing or technically incorrect, are outlined below.

In any event, if the bill is to remain in substantially its present form, the effective date should be postponed until taxable years beginning after December 31, 1964, in order to allow taxpayers and their representatives to become familiar with it. To accomplish this change, section 216(1) should be amended to read as follows:

"(1) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1964."

QUESTION OF UNDUE LIMITATION

Bill section 216(d) (IRC sec. 543(a)(2)):

"(2) RENTS.—The adjusted income from rents; except that such adjusted income shall not be included if—

"(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

"(B) the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties, and the adjusted income from mineral, oil, and gas royalties) is not more than 10 percent of the ordinary gross income."

Comment: This subsection provides that adjusted gross income from rents (gross income less deductions for depreciation, property taxes, interest, and rent) is personal holding company income except where (1) such adjusted gross income constitutes 50 percent or more of the corporation's adjusted ordinary gross income and (2) the personal holding company income for the taxable year is not more than 10 percent of the ordinary gross income. The result is that where a corporation which owns and operates an office building or apartment house has funds invested in securities set aside as a reserve to provide for repairs or renovations of the buildings or to use in acquiring additional property and the income from such securities amounts to more than 10 percent of the ordinary gross income for the taxable year, then, regardless of other considerations, the income from rents will constitute personal holding company income.

Although the committee is in sympathy with the objective of preventing the use of rental properties to avoid the application of the personal holding company tax to substantial income from investments, it believes that the 10 percent test is too severe and prevents the holding of investments in securities for legitimate business purposes by a corporation whose primary business is the operation of rental properties. The 50 percent test in its proposed form is sufficient to prevent abuses in this area and the committee suggests that the 10 percent test be eliminated, or in the alternative, that if some test must be included based on a percentage of personal holding company income to adjusted gross income, the percentage be increased from 10 to 20 percent.

Suggestion: The amendment of paragraph (B) of code section 543(a)(2) by section 216 of the bill should be stricken or, in any event, the figure "20" should be substituted for the figure "10" in the last line of the amendment.

QUESTION OF RETROACTIVITY

Bill section 216(f) (IRC, sec. 562(b)):

"(b) DISTRIBUTIONS IN LIQUIDATION.—

"2. In the case of a complete liquidation of a personal holding company, occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan shall be treated as a dividend for purposes of computing the dividends paid deduction(s), to the extent that such amount is distributed to corporate distributees and represents such corporate distributees' allocable share of the undistributed personal holding company income for the taxable year of such distribution computed without regard to this paragraph and without regard to subparagraph (B) of section 316(b)(2)."

Comment: The proposed amendment to section 562(b) would deny to personal holding companies a dividends paid deduction for distributions made pursuant to a plan of liquidation. Under present law the deduction is available to personal holding companies (as well as other corporations) if the distribution occurs within 24 months after the adoption of the plan. The proposal would permit the deduction only to the extent amounts distributed to shareholders other than corporations are designated as dividend distributions and these amounts would be taxed as dividends to the recipients.

This could result in discrimination in the case of shareholders of corporations that had adopted a plan of liquidation prior to the release of H.R. 8363 on September 10. For example, the stock of some stockholders may have been redeemed, but not the stock of other stockholders. Frequently, operating companies become personal holding companies during liquidation so that special consideration is appropriate. The requirement that the liquidation be completed in 24 months adequately protects the revenue.

Suggestion: It is suggested that corporations which had adopted a plan of complete liquidation prior to September 10, 1963, be able to avail themselves of the deduction in the same manner as under present law if the liquidation is completed within 24 months. For this purpose, it is suggested that proposed section 562(b)(2) be changed by adding before the period at the end thereof, the following:

"and if such plan was adopted prior to September 10, 1963, any distribution within such period pursuant to such plan, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution was made."

No change in the proposed amendment to section 316(b) of the code would appear to be necessary.

QUESTION OF HARDSHIP

Bill section 216(g) (IRC, secs. 333(g)(1)(A) and 333(g)(2)(A)(i)).

"(1) LIQUIDATIONS BEFORE JAUNARY 1, 1966.—In the case of a liquidation occurring before January 1, 1966, of a corporation referred to in paragraph (3)—

("(A) the date 'December 31, 1953' referred to in subsections (e)(2) and (f)(1) shall be treated as if such date were 'December 31, 1962.'"

* * * * * * *

"(2) LIQUIDATIONS AFTER DECEMBER 31, 1965.—

"(A) IN GENERAL.—In the case of a liquidation occurring after December 31, 1965, of a corporation to which this subparagraph applies—

"(i) the date 'December 31, 1952' referred to in subsections (e)(2) and (f)(1) shall be treated as if such date were 'December 31, 1962.'"

Comment: Throughout this subsection, the date August 1, 1963, is used as a cutoff date for earnings and profits and as the status date for ownership of qualified indebtedness. It is inconsistent to use an earlier acquisition date in determining which securities may be distributed free of tax.

Suggestion: Code sections 333(g)(1)(A) and 333(g)(2)(A)(i) should each be amended by substituting "July 31, 1963" for "December 31, 1962."

QUESTION OF INTERPRETATION

Bill section 216(g) (IRC, section 333(g)):

"(g) SPECIAL RULE.—

"(3) CORPORATIONS REFERRED TO.—For purposes of paragraphs (1) and (2), a corporation referred to in this paragraph is a corporation which for at least one of the two most recent taxable years ending before the date of the enactment of this subsection was not a personal holding company

under section 542, but would have been a personal holding company under section 543 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year."

Comment: At first glance section 333(g) would appear to be a self-contained subsection of section 333 so that the fact that a corporation is collapsible (which would thereby make it ineligible generally for sec. 333 treatment) is irrelevant. This is so because both paragraphs (1) and (2) refer to paragraph (3) for the classes of corporations eligible for treatment thereunder, and the latter paragraph makes no reference to the collapsible limitation.

However, the effect of paragraphs (1) and (2) is to substitute later dates or other language in sections 333(e)(2) and 333(f)(1), each of which paragraphs, under existing law, presupposes a corporation qualifying under section 333(a); i.e., a domestic corporation which is not collapsible. Perhaps for this reason the House Ways and Means Committee report (Technical Explanation p. A108) states that the liquidation referred to in new section 333(g) is one "to which section 333(a) applies."

The same considerations which support the relief granted to a corporation other than a collapsible corporation warrant the application of the relief provisions to a collapsible corporation which becomes a personal holding company because of the 1963 amendment. The committee therefore suggests section 333(g) be amended to make it clear that its benefits extend to collapsible corporations. At the very least, if the intent of Congress is otherwise, the bill should be amended to make it clear that its benefits extend only to corporations qualifying under section 333(a).

Suggestion: The committee suggests that paragraph (3) of section 333(g) be amended to read as follows:

"(3) Corporations referred to.—For purposes of paragraphs (1) and (2), a corporation referred to in this paragraph is a domestic corporation (whether or not a collapsible corporation to which sec. 341 applies) which * * *."

In the alternative, paragraph (3) should be amended to read as follows:

"(3) Coporations referred to.—For purposes of paragraphs (1) and (2), a corporation referred to in this paragraph is a corporation described in subsection (a) which * * *."

QUESTION OF INCOMPLETENESS

Bill section 216(i) (IRC sec. 545(c)(1)):

"(1) In general.—Except as otherwise provided in this subsection, for purposes of subsection (a) there shall be allowed as a deduction amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness."

Comment: Section 216(i) of the bill provides for a deduction in the computation of undistributed personal holding company income of amounts used or irrevocably set aside to pay or retire "qualified indebtedness."

Where a corporation becomes a personal holding company for the first time because of the 1963 amendments, the same considerations which support a deduction for amounts set aside to pay or retire indebtedness warrant a deduction for amounts paid or set aside to retire preferred stock in cases where the taxpayer is contractually obligated to retire such stock.

Suggestion: The committee therefore suggest that paragraph (1) be amended to read as follows:

"(1) In general.—Except as otherwise provided in this subsection, for purposes of subsection (a) there shall be allowed as a deduction amounts used, or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness), to pay or retire qualified indebtedness or to redeem or retire qualified preferred stock."

A definition of "qualified preferred stock" parallel to the definition of "qualified indebtedness" (as proposed to be amended by the second following suggestion) should likewise be added.

QUESTION OF INADEQUACY OF RELIEF PROVISION

Bill section 216(i) (IRC, sec. 545(c)(5)(A)):

"(A) the amount, if any, by which—

"(i) the deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, or amortization (other than such deductions which are disal-

lowed in computing undistributed personal holding company income under subsection (b)(8)), exceed

"(ii) any reduction, by reason of this subparagraph, of the deductions otherwise allowed by this subsection for such preceding taxable years, and. * * *"

Comment: Under section 351 of the Revenue Act of 1934 which first imposed a personal holding company tax, the income subject to such tax was reduced by any amounts used or set aside to retire indebtedness incurred prior to January 1, 1934. On the other hand, the proposed amendment would only permit a deduction to the extent that payments on indebtedness in effect exceeded depreciation money.

If this relief provision is not broadened, many such corporations will be forced to avail themselves of the liquidation provisions, which will result in important and substantial parcels of real estate becoming owned by various individuals as tenants in common and thereby expose such real estate to serious title and management problems. Furthermore, if only indebtedness incurred prior to August 1, 1963, will qualify, any alleged unfair advantage gained by existing corporations will gradually disappear through the process of attrition.

Suggestion: Subparagraph (A) should be deleted in its entirety and the phrase "the sum of" deleted in the last line immediately preceding subparagraph (A).

QUESTION OF UNDUE RESTRICTION ON RELIEF PROVISION

Bill section 216(i) (IRC, sec. 545(c)(3)(B)):

"(B) EXCEPTION.—For purposes of subparagraph (A), qualified indebtedness does not include any amounts which were, at any time after July 31, 1963, and before the payment or set-aside, owed to a person who at such time owned (or was considered as owning within the meaning of section 318(a)) more than 10 percent in value of the taxpayer's outstanding stock."

Comment: This subparagraph limits the definition of "qualified indebtedness" to exclude indebtedness owed to an actual or constructive owner (within the meaning of sec. 318(a)) of more than 10 percent in value of the taxpayer's stock. The committee believes that exclusion from qualified indebtedness of amounts owed to persons who are actually shareholders, and to their spouses and minor children, and perhaps to others with a close relationship, is proper. However, incorporation of the constructive ownership rules of section 318(a) brings in relationships which the committee considers to be far too remote to warrant exclusion from the definition of "qualified indebtedness." For instance, under section 318 it is possible to attribute ownership from one individual to another if both happen to be beneficiaries of the same estate or trust or partners in some unrelated enterprise. In most instances such constructive ownership is then treated as actual ownership for the purpose of again applying the rules of section 318.

Suggestion: The committee therefore suggests that subparagraph (B) be amended to read as follows:

"(B) EXCEPTION.—For purposes of subparagraph (A), qualified indebtedness does not include any amounts which were, at any time after July 31, 1963, and before the payment or set-aside, owed to a person who at such time owned more than 10 percent in value of the taxpayer's outstanding stock, the spouse or minor child of such person, a trust for the benefit of a spouse or a minor child of such person, a corporation of which such person is in control (within the meaning of section 368(c)), or a partnership in which such person owns an interest in capital or profits of more than 50 per centum."

QUESTION OF CLARIFICATION

Bill section 216(j)(1) (IRC, sec. 1022):

Comment: This paragraph of the bill, while it adds a new section 1022 to the code providing for an increase in the basis of foreign personal holding company shares acquired from the decedent to the extent of the amount of the estate tax attributable to the appreciation of the decedent's basis, makes no reference to section 1014(b)(5) of the code which is the applicable basis section.

Suggestion: The bill should amend section 1014(b)(5) of the code by the addition of the following language at the end thereof:

"Adjusted, however, to the extent provided in section 1022."

QUESTION OF ADMINISTRATIVE IMPLEMENTATION

Bill section 216(j)(4):

"(4) ONE-MONTH LIQUIDATIONS.—If—

"(A) a corporation was a foreign personal holding company for its most recent taxable year ending before the date of the enactment of this Act,

"(B) all of the stock of such corporation is owned on August 15, 1963, and at the time of liquidation, by individuals and estates, and

"(C) the transfer of all the property under the liquidation occurs within one of the first four calendar months ending after such date of enactment, then such corporation shall be treated as a domestic corporation for purposes of section 333 of the Internal Revenue Code of 1954 (relating to one-month liquidations), and shall be treated as a foreign corporation for purposes of section 367 of such code (relating to foreign corporations). In applying such section 367 for purposes of this paragraph, references in the first sentence of such section 367 to other sections of such code shall be treated as including a reference to such section 333."

Comment: This paragraph makes available to a foreign personal holding company the 1-month liquidation provisions of section 333. However, the House committee report (technical explanation, p. A120) makes it clear that as in the case of other foreign corporations, a necessary prerequisite is an advance ruling of the Commissioner that tax avoidance was not one of the principal purposes of the transaction. The requirement that the liquidation be completed within 1 of the first 4 calendar months ending after the date of enactment of the bill may make it difficult for the taxpayer to submit its ruling request, for the Commissioner to act thereon, and for the liquidation to occur all before the end of the 4th calendar month.

Suggestion: The committee suggests that subparagraph (C) be amended to read as follows:

"(C) the transfer of all the property under the liquidation occurs within one of the first four calendar months ending after the date of receipt of a written ruling of the Secretary or his delegate under section 367 if the taxpayer applies for such ruling within the first four calendar months ending after the date of enactment of this Act."

QUESTION OF FAILURE TO INCLUDE PROVISIONS IN INTERNAL REVENUE CODE

Bill section 216(j)(4)-(7):

Comment: Sections 216(j)(4)-(7) contain certain relief provisions relating to the liquidation of foreign personal holding companies under section 333 and to related basis provisions. As presently drafted, these provisions would not be included in the Internal Revenue Code.

The committee's opinion is that all of the provisions of section 216(j)(4)-(7) of the bill should be included in the Internal Revenue Code. The statute in question relates to filing requests for rulings in timely fashion and to basis provisions which may affect a good many unsuspecting taxpayers. The committee's suggestion is simply to include these provisions in the code, leaving it to Congress to select the proper location.

Suggestion: The committee suggests that bill sections 216(j)(4)-(7) be included in the Internal Revenue Code of 1954 at the appropriate place or places.

QUESTION OF INCONSISTENCY

Bill section 219(b) (IRC, sec. 1212):

Comment: Section 219 of the bill amends code section 1212 by making the existing 5-year capital loss carryover applicable only to corporations; noncorporate taxpayers are to receive an unlimited capital loss carryover. The reason for the amendment as stated in the House Ways and Means Committee report (general explanation, p. 96) is to "increase the volume of funds available for investment in new and risky enterprises." The committee perceives no reason why that reason is not equally applicable to investments by corporations in such enterprises.

Suggestion: The committee suggests that section 1212(a) of the code, as amended by section 219 of the bill, be further amended to read as follows:

"(a) If for any taxable year a corporation has a net capital loss, the amount thereof shall be a short term capital loss in each of the succeeding taxable years

to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this section, a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years, and a net capital loss for a taxable year beginning before October 20, 1951, shall be determined under the applicable law relating to the computation of capital gains and losses in effect before such date."

QUESTION OF UNDUE COMPLEXITY

Bill section 220(a) (IRC, sec. 1250):

Comment: The House Ways and Means Committee report (general explanation, p. 13) states that the revenue produced by section 220 of the bill will be less than 2½ million dollars in calendar 1974 and $5 million in calendar 1965. The committee questions very seriously whether the extremely complex provisions of section 220, which occupies over 14 pages in the committee print, are justified by such a small increase in potential revenue. This is particularly so since this section, like code section 1245, as added by the Revenue Act of 1962, may create taxable ordinary income in many situations where under existing law gain is not generally recognized. This overriding recognition of ordinary income is already creating serious problems as between sellers and buyers of corporate businesses who prior to the 1962 act could accommodate their conflicting desires by utilizing either section 334(b)(2) or section 337.

Suggestion: The committee suggests either that section 220 of the bill be deleted in its entirety or that a much more simplified version be drafted in lieu thereof.

QUESTION OF DIFFICULTY OF INTERPRETATION

Bill section 220(a) (IRC, sec. 1250(b)(1)):

"(1) IN GENERAL.—The term 'additional depreciation' means, in the case of any property, the depreciation adjustments in respect of such property; except that, in the case of property held more than one year, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under the straight line method of adjustment. For purposes of the preceding sentence, if a useful life (or salvage value) was used in determining the amount allowed as a deduction for any taxable year, such life (or value) shall be used in determining the depreciation adjustments which would have resulted for such year under the straight line method."

Comment: It is not clear under the language of this section whether additional depreciation is to be determined on a year-by-year basis or on an overall basis for the entire period of time that the property has been held. Example 2 on page A-151 of the committee report indicates that additional depreciation is to be determined by obtaining a total of all of the depreciation adjustments under paragraph 3 and subtracting from that total the total of what straight line depreciation would have been for the entire period. This method takes into account the possibility that the allowed or allowable depreciation for any year may be less than what straight line depreciation would have been. However, the unnumbered example on page A-152 of the committee report can possibly be interpreted to give a different result. In the unnumbered example, a situation is discussed in which the allowed depreciation for a particular year is zero, and it is stated that the additional depreciation for that year will be zero. This example implies that additional depreciation is to be determined on a year-by-year basis and that no consideration will be given to the possibility that the allowed or allowable depreciation for a particular year may be less than what straight line depreciation would have been. It appears that the basic purpose of section 1250 is to determine additional depreciation on an overall basis for the entire period without taking into account the result for any particular year.

Suggestion: Section 1250(b)(1) should be amended as follows: The words "such adjustments only to the extent that they exceed the" should be eliminated and the following should be inserted: "the excess of the total amount of adjustments determined under paragraph (3) over the total."

QUESTION OF IMPROPER APPLICATION OF SECTION

Bill section 220(a) (IRC, sec. 1250(b) (2)):

"(2) PROPERTY HELD BY LESSEE.—In the case of a lessee, in determining the depreciation adjustments which would have resulted in respect of any building erected (or other improvement made) on the leased property, or in respect of any cost of acquiring the lease, the lease period shall be treated as including all renewal periods. For purposes of the preceding sentence—

"(A) the term 'renewal period' means any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, but

"(B) the inclusion of renewal periods shall not extend the period taken into account by more than ⅔ of the period on the basis of which the depreciation adjustments were allowed."

Comment: Section 1250(b)(1) provides that in determining what straight line depreciation would have been, the same useful life used by the taxpayer in computing depreciation actually taken shall be used. Section 1250(b)(2) changes this rule where a lessee who has an option to renew a lease is amortizing the cost of leasehold improvements or the cost of the acquisition of the lease on the straight line method over the current term of the lease. By requiring that renewal terms be taken into consideration, a different useful life must be used. The right to amortize the cost of leasehold improvements or the cost of acquiring a lease on the straight line method over the current term of the lease is based upon the rules contained in section 178 of the code, which take into account many factors in determining whether renewal terms must be taken into consideration. It is unfair and unduly harsh, for purposes of section 1250, to require the automatic assumption that a lease will be renewed without taking into account any of the provisions of the factors which are relevant under section 178.

Suggestion: The committee suggests that section 1250(b)(2) be entirely eliminated.

QUESTION OF IMPROPER DEFINITION

Bill section 220(a) (IRC sec. 1250(c))

"(c) SECTION 1250 PROPERTY.—For purposes of this section, the term 'section 1250 property' means any real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167."

Comment: Section 1250(c) defines the term section 1250 property. The definition is inadequate for two reasons. It fails to recognize the fact that certain leaseholds are not real property, and that the writeoff of certain costs connected with a lease may be amortization rather than depreciation.

Suggestion: The committee suggests that section 1250(c) be amended to provide as follows:

"(c) SECTION 1250 PROPERTY.—For purposes of this section, the term 'section 1250 property' means any interest in real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for amortization under Section 162 or the allowance for depreciation provided in Section 167."

QUESTION OF POSSIBLE DOUBLE RECAPTURE

Bill section 220(a) (IRC sec. 1250(d)(3)):

"(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter."

Comment: This paragraph provides that generally speaking there shall be no taxable recapture of depreciation in carryover basis situations, including liquidations of subsidiaries, tax-free organizations of corporations, transfers of property pursuant to reorganizations, receivership and bankruptcy reorganizations, certain railroad reorganizations, or contributions to or distributions by a

partnership. However, the last sentence provides that this exception does not apply to any disposition to a tax exempt organization which might happen to be a recipient of section 1250 property in any of the above described transactions. The reason is that any disposition of the property by an exempt organization "ordinarily would escape the recognition of ordinary income with respect to [the depreciation] deductions." (House committee report, general explanation, p. 106.)

However, where disposition of the property by an exempt organization occurs at a time when the property is being used in connection with an unrelated trade or business, it is possible that a double recapture of depreciation might result. While section 512(b) (5) excludes from the definition of "unrelated business taxable income" all gains from the sale or exchange or other disposition of property which is not inventory or held for sale to customers in the ordinary course of a trade or business, it is possible that the overriding recognition of gain prescribed by section 1250 could nullify this exclusion (although it may be observed, that section 512(b) (5) is an exclusion and not a nonrecognition provision).

To avoid this possibility of double recapture, the committee is of the opinion that an adjustment to basis should be allowed to an exempt organization receiving property in one of the categories of transactions set forth in section 1250 (d) (3). Since section 1250(g) delegates the function of prescribing basis adjustments to the Secretary or his delegate, the appropriate place for such a provision would be in the regulations.

Suggestion: To bring this matter to the Commissioner's attention when the regulations are drafted, it is suggested that the committee report contain a statement along the following lines:

"An upward adjustment of basis, for instance, would seem appropriate where property is distributed to an exempt organization in one of the transactions described in section 1250(d) (3) in which gain is recognized to the transferor."

QUESTION OF FAILURE TO CROSS REFERENCE

Bill section 220(a) (IRC, sec. 1250(a) (last sentence), (h)):

"(a) * * * Such gain shall be recognized notwithstanding any other provision of this subtitle.

* * * * * * *

"(h) APPLICATION OF SECTION.—This section shall apply notwithstanding any other provision of this subtitle."

Comment: Proposed code section 1250, like section 1245 as added by the Revenue Act of 1962 (sec. 1245(a), last sentence, and sec. 1245(d)) provides for recognition of ordinary income on any disposition of real property (subject to enumerated exceptions) notwithstanding that the disposition is pursuant to a transaction under which gain or loss is generally unrecognized. Two significant examples of such transactions are liquidations of subsidiaries under section 332 (where a step-up in basis under sec. 334(b) (2) is involved) and sales pursuant to 12-month liquidations under section 337. Neither section 1245 of existing law nor proposed section 1250 is cross referenced in either of these sections, nor in section 336 (dealing with the effect of liquidation on the corporation itself) thus creating a trap for the unwary taxpayer or his practitioner.

Suggestion: The committee suggests that cross references to sections 1245 and 1250 be aded to code sections 336 and 337, and to such other sections of the code providing nonrecognition of gain or loss as do not come within the specified exceptions in proposed sections 1250 and 1245 of existing law.

QUESTION OF CLARIFICATION

Bill section 223(a) (IRC, sec. 1561(a)(2)):

"(a) GENERAL RULE.—If a corporation is a component member of a controlled group of corporations on a December 31, then for purposes of this subtitle the surtax exemption of such corporation for the taxable year which includes such December 31 shall be an amount equal to—

"(1) $25,000 divided by the number of corporations which are component members of such group on such December 31, or

"(2) if all such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan, such portion of $25,000 as is apportioned to such member in accordance with such plan.

"The sum of the amounts apportioned under paragraph (2) among the component members of any controlled group shall not exceed $25,000."

Comment: Section 1561(a) permits component members of a controlled group to divide the surtax exemption equally between them or to agree upon an apportionment plan under which the $25,000 exemption is to be apportioned in accordance with such plan.

Under this provision it is not clear whether the division of the exemption agreed upon can be adjusted in the event the surtax exemption of one of the members is disallowed. It is believed that this omission can be properly covered in the committee report.

Suggestion: The committee suggests that there be added at the end of the first paragraph appearing at the top of page A188 the following sentences:

"In the event that the portion of the surtax exemption apportioned to a component member under section 1561(a) (1) or (2) is disallowed, as, for example, under section 269, the portion of the exemption so disallowed shall be apportionable to the other component members of the group proportionately."

QUESTION OF SUBSTANTIAL INEQUITY

Bill section 223(a) (IRC, sec. 1563(a)(2)):

"(a) CONTROLLED GROUP OF CORPORATIONS.—For purposes of this part, the term 'controlled group of corporations' means any group of—

"(2) BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsec. (d)(2)) by one person who is an individual, estate, or trust."

Comment: This section contains the definition of a brother-sister controlled group and provides that if 80 percent of the total combined voting power and total value of shares of all classes of stock of each of two or more corporations is owned by one person who is an individual, estate, or trust, the corporations are considered members of a brother-sister controlled group.

Under this definition separate surtax exemptions will be denied where an individual owns two completely separate businesses. The only exception is that provided in the case of a husband and wife as set forth in section 1563(e)(5). The committee believes that where, for example, an individual owns an automobile agency and a lumberyard, both in corporate form, the two corporations should each be permitted separate surtax exemptions. The surtax exemption should be restricted only in cases where the businesses are related.

Suggestion: Section 1563(a)(2) should be amended to read as follows:

"(2) BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations engaged in related businesses if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsec. (d)(2)) by one person who is an individual, estate, or trust. As used in this paragraph, the term 'related businesses' means two or more businesses, wherever located,

"(A) furnishing similar or related products or services, if more than 30 percent of the gross receipts of each such business is derived from the sale of such products or services, or

"(B) furnishing products or services to any other corporation which, but for this sentence, would be a component member of the controlled group, if more than 10 percent of the gross receipts or such business is derived from the sale of such products or services."

QUESTION OF OMISSION

Bill section 223(a) (IRC sec. 1563(b)(2)):

(b) COMPONENT MEMBER.—

"(2) EXCLUDED MEMBERS.—A corporation which is a member of a controlled group of corporations on December 31 of any taxable year shall be treated as an excluded member of such group for the taxable year including such December 31 if such corporation—

"(A) is a member of such group for less than one-half the number of days in such taxable year which precede such December 31.

"(B) is exempt from taxation under section 501(a) (except a corporation which is subject to tax on its unrelated business taxable income under section 511) for such taxable year,

"(C) is a foreign corporation subject to tax under section 881 for such taxable year,

"(D) is an insurance company subject to taxation under section 802 or section 821 (other than an insurance company which is a member of a controlled group described in subsection (a)(4)), or

"(E) is a franchised corporation, as defined in subsection (f)(4)."

Comment: This section lists those corporations which are to be excluded from application of the rules relating to controlled groups of corporations. It includes corporations such as those which are exempt under section 501(a), foreign corporations subject to tax under section 881, and insurance companies subject to tax under section 802 or 821.

The committee believes that there should be added to this list corporations deriving income from sources within the possession of the United States under section 931, since such corporations cannot file consolidated returns. (See sec. 1504(b)(4).)

Suggestion: The committee suggests that a new subparagraph (F) be added to section 1563(b)(2) as follows:

"(F) is a corporation deriving income from sources within possessions of the United States under section 931."

QUESTION OF CLARIFICATION

Bill section 208 (IRC, sec. 165(c)(3))

"(a) *Limitation on Amount of Casualty or Theft Loss Deduction.*—Section 165(c)(3) (relating to losses of property not connected with trade or business) is amended to read as follows:

"(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return."

Comment: The provision that a loss is allowed only to the extent that the loss "arising from each casualty, or from each theft, exceeds $100" may cause great confusion where embezzlements are involved. Regulation section 1.165-8(d) defines "theft" as including larceny, embezzlement, and robbery. If there is a systematic weekly embezzlement of $100, it is probable that an examining agent would contend that there was a series of separate embezzlements, and would apply the $100 deduction to each weekly embezzlement. The result would be no embezzlement deduction despite the loss of $5,200 in 1 year. The House Ways and Means Committee report ("General explanation," p. 52) states that "in determining what is a single casualty it is intended that the law be interpreted liberally." However, it would be preferable to state, as an example of such interpretation, that a series of embezzlements are considered to be one casualty.

Suggestion: The committee suggests that a sentence of the following import be inserted in the Senate Finance Committee report immediately after the sentence quoted above:

"For instance, a series of small embezzlements of his employer's money by an employee would normally be considered to be a single casualty."

The committee also desires to go on record as being in agreement with the rejection by the House Ways and Means Committee of provision for the taxation of a wholly unrealized and therefore fictitious gain upon the death of an individual taxpayer, or in substitution therefor, the carryover of the decedent's basis to his successors. The committee strongly urges that no such provision be inserted in the bill by the Senate Finance Committee.

The imposition of a capital gain tax on death would amount to a substantial increase in the taxes payable under existing law by reason of the death of a decedent and would make it more difficult to avoid distress sales of small busi-

ness and other nonliquid assets owned by decedents. Imposition of such a tax also violates the longstanding principle of Federal income taxation that no tax shall be imposed until gain is in fact realized by a meaningful economic disposition of the appreciated property.

Requiring a carryover of the decedent's basis to his successors would create difficult problems of basis tracing, possibly through the estates of all decedents dying since March 1, 1913. It would also increase the tax burdens of estates which must sell assets to pay the estate tax or expenses of administration and therefore make it more difficult to avoid distress sales of small businesses owned by the decedent.

Respectfully submitted.

LEONARD SARNER, *Chairman.*

AMERICAN LIBRARY ASSOCIATION,
Washington, D.C., December 5, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The enclosed statement embodies the views of the American Library Association in regard to extending the 30-percent limitation on income tax deductions for charitable contributions to public libraries. Under the present Internal Revenue Code such contributions to public libraries are subject to a 20-percent limitation.

Section 209 of H.R. 8363, the Revenue Act of 1963, as passed by the House of Representatives, would amend the Internal Revenue Code so as to extend the 30-percent deduction to certain additional types of organizations. According to House Report 749 (p. 53) among the types of organizations which generally would in the future qualify for the additional 10-percent deduction under section 209 are publicly and governmentally supported libraries.

The American Library Association urges that the provisions of section 209 of H.R. 8363 be retained in the bill as approved by your committee. It also urgently recommends that the Senate report accompanying the bill make clear the eligibility of publicly and governmentally supported libraries for the 30-percent limitation on deductions for charitable contributions under this provision.

We should be glad to have this letter and the attached statement made a part of the record of the Senate hearings on H.R. 8363.

Sincerely yours,

GERMAINE KRETTEK, *Director.*

STATEMENT OF GERMAINE KRETTEK, ASSOCIATE EXECUTIVE DIRECTOR, AMERICAN LIBRARY ASSOCIATION, SUBMITTED TO THE HOUSE COMMITTEE ON WAYS AND MEANS ON THE PRESIDENT'S TAX PROPOSAL TO EXTEND THE 30-PERCENT LIMITATION ON DEDUCTIONS FOR CHARITABLE CONTRIBUTIONS, MARCH 7, 1963

My name is Germaine Krettek. I am associate executive director of the American Library Association, a nonprofit, professional association of approximately 25,000 members, consisting of librarians, public library trustees, and members of the general public interested in the development, extension, and improvement of libraries as essential factors in the educational program of our Nation.

The American Library Association supports the recommendation that public libraries be included under the provisions of the proposed legislation which would allow charitable contributions up to 30 percent. By public library is meant any institution which is operated for the benefit of the general public and receives its financial support in whole or in part from any State or political subdivision thereof, or from the United States.

The association contends that public libraries are educational institutions and should be included in the extra 10-percent deduction which is allowed under the present law to schools, colleges, and universities.

In substantiation of this position that public libraries should be considered educational institutions we should like to submit the following facts, including Federal and State laws, Federal regulations, and court rulings. Among those which have pertinence are the following:

1. The Congress in 1962 amended the Federal Property and Administrative Services Act of 1949 so as to permit donations of surplus personal property to * * * public libraries. In House Report No. 2433, 87th Congress, in support of this legislation it is stated that "public libraries, though widely recognized as being educational institutions and eligible to recieve surplus real property * * * have not been considered eligible to receive surplus personal property * * *. This anomaly in the legislation would be removed by the enactment of H.R. 11378." The report also emphasized that the inclusion of public libraries was not adding a new category but merely clarifying the status of public libraries as coming within the educational category (Public Law 87–786).

2. In 1956 the Congress recognized that public libraries are educational institutions and authorized in the Library Services Act (Public Law 84–597) an annual appropriation of $7.5 million for a period of 5 years to assist the States in extending and improving their public library services to rural areas. This act was amended in 1960 to extend the legislation for an additional 5 years (Public Law 86–679). The underlying basis for the original act and the 1960 amendment was the judgment that public libraries are educational agencies. For instance, House Report 1587, 84th Congress, 1st session stated: "There can be no question that the free, tax-supported library, where it has been adequately supported, is an integral part of public education in the many communities where it exists."

3. The regulations issued under the controlled materials plan in 1951 specifically recognized public libraries as educational institutions and placed them with schools, universities, and colleges to receive their proportional allotments of critical materials in short supply during the Korean crisis. The determination of the quantities of materials to be allotted was made from the quotas allowed educational institutions.

4. All States have laws which provide for the organization of public libraries and their maintenance by taxes. Public libraries are thus publicly supported institutions.

5. Among the State court decisions on the public library as educational institutions these might be cited:

In *School City of Marion* v. *Forrest*, 168 Ind. 94, the Supreme Court of Indiana declared:

"* * * It may, with propriety be said that a law providing for the organization and maintenance of public libraries is a part of the educational system of the State, * * *"

In *Webster City* v. *Wright County*, 144 Iowa 502, the Supreme Court of Iowa declared:

"* * * We feel justified in saying, then, that under all known rules of construction a public library is an educational institution, and that the trial court was right in allowing the exemption."

In *Board of Trustees, Newport Public Library* v. *City of Newport*, 300 Ky. 125, the court stated that the public library:

"* * * provides for the youth a medium for extra curricular research to supplement the basic principles taught in the classroom; it provides a facility for those to continue their education who, perforce, have abandoned attendance upon the public schools; and it is an institution which permits the adult, even though he may have completed the highest prescribed course of education, to continue his studies and improve his culture. In either event, the library raises the standard of knowledge and education."

In all fairness, we feel that public libraries as educational institutions should be entitled to inclusion under the 30-percent charitable deduction. It would encourage individuals to make donations, either in cash or in the form of books and related materials, to the public library which serves all the people in a community. Furthermore, those individuals who choose the public library as the educational institution to which they prefer to make their donations would then receive equal tax treatment with those who give to other types of educational institutions.

It is a source of gratification to the association that two members of this committee have introduced in this session bills (H.R. 498 by Representative Keogh and H.R. 2078 by Representative Curtis) which would extend the 30-percent charitable deduction to museums and libraries.

The American Library Association, therefore, strongly urges that the committee and the Congress take favorable action on the proposal to extend the 30-percent limitation on deductions for charitable contributions.

ARKANSAS OIL MARKETERS ASSOCIATION, INC.,
Little Rock, Ark., December 2, 1963.

Hon. HARLY FLOOD BYRD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Our association is composed of independent oil jobbers engaged in the distribution of petroleum products. We are very much concerned with the new proposed tax bill. At the present time very few jobbers are managing to make a return from their business other than average living expenses. We feel that some provision in the new tax bill should be set up so that a small-businessman could build up an equity in his business over a period of years which would insure to him if there are no sons to carry on the business for his family in the event of his death. Under this new bill, a jobber would have to hold every piece of realty for a period of 10 years before he could recover full capital gains treatment on resale.

We strongly support the following changes be made in H.R. 8363:

First, the individual income tax rates in the $15,000 to $50,000 bracket should be reduced more than is reflected in the present bill. To do otherwise will seriously jeopardize that portion of the small business community who operate as sole proprietors or partners.

Second, we recommend that the taxation on corporate income be as follows: 22 percent on the first $25,000 of the taxable corporate income, 30 percent on the next $75,000 of income (up to $100,000), and the normal tax of 22 percent plus the surtax of 30 percent, graduated downward as provided in H.R. 8363, be applied to corporate income in excess of $100,000. If this is not done, then the provisions relating to multiple corporations should be stricken from the bill, and the provisions under current law be continued where each corporation was entitled to the separate $25,000 breakoff point regardless of common ownership.

Third, it is recommended that the provisions relating to capital gains on certain depreciable real property be changed in such a manner as to deprive entrepreneurs of tax windfalls, but at the same time, give the full capital gains treatment to businesses and businessmen who have demonstrated by a historical basis of operation that they are not in-and-out business enterprises. For example, if an establishment has been engaged in a particular line of business for a period of 10 years, full capital gain would be given on a sale of all or part of its business assets after such assets had been held for a minimum period of 2 years.

Sincerely yours,

B. B. COOK, *Secretary.*

(Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Friday, December 6, 1963.)

REVENUE ACT OF 1963

FRIDAY, DECEMBER 6, 1963

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 (chairman) presiding.

Present: Senators Byrd, Douglas, Gore, Williams, Carlson, Bennett, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

We are honored today by having the Honorable Mrs. Neuberger with us, U.S. Senator from Oregon. You may proceed, Mrs. Neuberger.

STATEMENT OF HON. MAURINE B. NEUBERGER, A U.S. SENATOR FROM THE STATE OF OREGON

Senator NEUBERGER. Thank you, Mr. Chairman.

My amendment, No. 209, would liberalize the child care tax deduction provision contained in H.R. 8363 as passed by the House. President Kennedy, in his tax message to Congress on January 24, 1963, stated:

2. A MORE LIBERAL CHILD CARE DEDUCTION

Employed women, widowers, and divorced men are now allowed a deduction of up to $600 per year for expenses incurred for the care of children and other dependents who are unable to care for themselves. In its present form this provision falls far short of fulfilling its objective of providing tax relief to those who must—in order to work—meet extra expenses for the care of dependents.

Still quoting from the President—

I recommend increasing the maximum amount that may be deducted from the present $600 to $1,000 where three or more children must be cared for. I also recommend three further steps: Raising from $4,500 to $7,000 the amount of income that families with working wives can have and still remain fully eligible; increasing the age limit of children who qualify from 11 to 12; and extending the deduction to certain taxpayers who now do not qualify—such as a married man whose wife is confined to an institution.

The revenue cost of these changes in the child care deduction would be $20 million per year, most of which would benefit taxpayers with incomes of less than $7,000.

When the House of Representatives passed the tax legislation last September I regret to report that most of the important recommendations made by President Kennedy for child care deductions were not part of the bill.

The House-passed tax bill provides no meaningful child care deductions for working mothers. Under present law the maximum deduction of $600 is available to a married working mother only if she and her husband, together have a combined income of less than $5,100. However, for every dollar they earn over $4,500 they must subtract a dollar from the maximum $600 allowance.

Under the House bill married working women remain limited to a $600 deduction. The $4,500 limitation is retained. One liberalization the House would make is to allow a $900 deduction for two or more dependents for widows, widowers, and single women; but not for married women. The House also provided an increase in the age limit of children who qualify from 11 to 12, and the deduction for a married man whose wife is confined to an institution. It almost looks as if the Congress of the United States is prejudiced against married women working and, by this kind of distinction, are trying to force them to stay home. To me it reflects an old-fashioned opinion of the House that married women aren't supposed to work.

It seems obvious that if the child-care deduction should be increased for some categories it should be increased for all; our concern is for the child.

I believe if the mother can see her way clear to have good child care while she is working, that she is very likely to put the child in a nursery school, a group center, a day-care center of some kind, rather than leaving it to inadequate care provided she gets some compensation for the expenses she has.

The $4,500 income limitation was adopted as a part of the 1954 tax code, and since that time wages and the cost of living have risen considerably.

My argument is, then, if $4,500 was the limitation in 1954, 10 years later it is not unreasonable to ask for a $7,000 limitation.

Mr. Chairman, the joint husband-wife income limitation is so low in terms of present levels of income that the deduction is not available to most married women who have to work to supplement their husband's income. In the report of this committee in 1954 in connection with the child-care deduction, the committe stated:

> Moreover, it is recognized that in many low-income families, the earnings of the mother are essential for the maintenance of minimum living standards even where the father is also employed, and that in such situations the requirement for providing child care may be just as pressing as in the case of a widowed or divorced mother.

At present income levels, few families with working wives get any benefit from the child care deduction. Only 244,000 taxable returns claimed the deduction in 1960, of which 117,000 were joint returns of married couples. The median income of husbands who have wives in the labor force is $4,761, and in 1961 figures reported by the Department of Labor indicate that the median income of husband-wife families in which the wife worked at any time during the year was $7,050. For families in which the wife worked full time it was $8,517. Thus it is obvious that the present child care tax deduction has little meaning in terms of today's income.

Mr. Chairman, the question is not whether women and mothers would be encouraged to work through the child care tax deduction. Twenty-four million women are presently employed in our working

force, and I think it desirable to accept facts as they are. One worker in three in the United States today is a woman. By 1970 it is forecast that the work force will contain 30 million women. Their contribution to our society is enormous. Earlier this year recognizing this, the Congress enacted the Eqaul Pay Act of 1963 to provide equal pay per equal work.

The Department of Labor reports that there were 8.8 million working mothers with children under 18 years of age in March 1962 and about one-third of all mothers with children under 18 years of age were in paid employment. The Department of Labor further states that 5.4 million mothers who had children under 12 years of age were employed in 1958, with about 2.5 million of them working part time. Three out of ten mothers with husbands at home were employed. A serious question is raised by the fact that many mothers cannot afford to hire proper care for their children, especially because of the present low and unrealistic child care tax deduction. The number of working mothers in 1962 was in excess of 8.8 million and these numbers are still growing.

Mr. Chairman, I urge your committee to favorably consider my amendment to liberalize the presently inadequate child care tax deduction as recommended unanimously by the President's Commission on the Status of Women on which I served.

Mr. Chairman, I would like to call the committee's attention to my remarks which appear in the Congressional Record of December 4, 1963, page 22139, which include a favorable editorial from a Columbia, S.C., newspaper, the State. This editorial, dated November 20, 1963, states in part:

> Here is a true instance of denial of equal rights—and one which directly affects working women of all ages and all races in all parts of the country. * * * It is here that she is penalized, for our tax laws make meager provision for her deducting the expenses she incurs in order to become a taxpaying worker. * * * But it would seem reasonable to conclude that deductions are intended to allow a measure of relief for taxpayers who incur necessary expenses in the business of earning a living.

Mr. Chairman, I seek permission to place in the hearing record this editorial in its entirety.

(The editorial referred to follows:)

UNFAIR TAX LAWS

Senator Maurine Neuberger, liberal widow of the late liberal Senator from Oregon, generally is too far out in left field for our political tastes—but we give her full support on one point:

She contends that working mothers should be allowed tax deductions for housekeepers.

There is, in the Internal Revenue Code, a provision for child care deductions for working mothers who must work yet who must also see that their children are tended during the workday. But there are limitations on this type of deduction, and the deductions close out completely at a given point of earnings.

In short, this child care deduction is provided only as a help for the family; not as a reasoned and equitable tax provision.

Income tax laws, so far as we know, do not spell out the philosophy of tax deductions. But it would seem reasonable to conclude that deductions are intended to allow a measure of relief for taxpayers who incur necessary expenses in the business of earning a living.

And since earning a living involves earning enough to pay taxes, it would seem that the Government should be willing to play fair in the matter of deductions. But even without reference to fair play, it is simply good business for the

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Government to encourage the earning of good wages in order that those wages might produce tax revenues.

The woman who stays at home, whether by choice or by necessity, may be performing a useful function as housewife and homemaker but she is contributing a cook, maid, or babysitter to mind the house or tend the children. It is

If she goes to work, voluntarily or involuntarily, she not only becomes a breadwinner but a taxpayer. Furthermore, she becomes an employer herself by paying a cook, maid, or babysitter to mind the house or tend the children. It is here that she is penalized for our tax laws make meager provision for her deducting the expenses she incurs in order ot become a taxpaying worker.

This is a tax discrimination against the womenfolk, and it should be removed. Here is a true instance of denial of equal rights—and one which directly affects working women of all ages and all races in all parts of the country.

Senator NEUBERGER. Many national organizations are supporting my amendment. Some of them have or will testify or submit statements to your committee, and I am pleased that the national president of the Business and Professional Women's Clubs, my friend, Miss Virginia R. Allan, will testify later today in support of my amendment.

Mr. Chairman, last year, in connection with my work as a member of the Committee on Taxation and Social Insurance of the President's Commission on the Status of Women, I made a hurried trip to the Scandinavian countries because they are so frequently quoted to us as examples of places where adequate child care is provided. One of the most interesting experiences I had was visiting not just a day nursery but a whole child care center in the heart of the vast Carlsberg Brewery. It was a most interesting experience where the state provides part of the money for the nursery, and the brewery provides the other part. They said that it added greatly to the success and permanance of their work force, to have the women know that their children were well taken care of there.

But perhaps—we are familiar with infant care and the day nursery. The most interesting experience I had there was when I was accompanied by our Ambassador Blair. It was about 3 o'clock in the afternoon, and suddenly a new group of young people arrived at the child care center. They were sort of 12, 13, 14 years of age, and I said suddenly, "Well, who are these children, they certainly don't need day care."

Well, they are called the afternoon school, and they were immediately taken to a large room, kind of a library room, where there were books and magazines, and a study teacher there to help them with their problems, and their classwork. It was a beautiful sunny afternoon and some of them checked in and then went out in the playground which we could observe through the windows of the study room. And when I asked further about this, I really thought that maybe we have misdirected some of the money that we assign in the study of juvenile delinquency. Because here were the children who are most likely to be found on the street, the children of working mothers who are not home to receive these youngsters, when school is out. And they went to this partly state-supported school, to be supervised and to study until the mother or father was through with the job.

And, though that is not encompassed in my bill, I do think that it was something that we could learn to sort of model a program after. It was an example of the high state of civilized approach to the child care problem from infancy through the important teenagers.

That concludes my testimony, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Neuberger.
Any questions, Senator Gore?
Senator GORE. Senator Neuberger, I found your statement interesting, and I appreciate the work that you have done and the interest you have shown.
I notice you say that since 1954 the cost of living has risen considerably. That would certainly be an understatement if instead of 1954 you said 1940, wouldn't it?
Senator NEUBERGER. Oh, definitely, yes.
Senator GORE. Well, in 1940 a man and his wife had a tax exemption of $2,000. The theory upon which Congress has given tax exemption to a taxpayer and to a family has been that a minimum subsistence level of income should be available to a family before the heavy hand of the Federal Government lays a tax upon the income of that taxpayer or family.
As I say, a man and his wife had an income of $2,000 exempt from Federal taxation in 1940. Now, the cost of living is almost two and a half times as great, but that tax exemption is down to $1,200. What would be your feeling about making that provision in the law more realistic as compared with the cost of living, along with deductions for child care?
Senator NEUBERGER. Well, I am confining my concern for the child, and if you did that, Senator, then, of course, you would be helping the income level of a good many families who no doubt need it but who don't have children, and I would like to confine my concern with the child first. I am really not concerned with the father or the mother who gets the benefit. But I think the child will benefit by the mother getting this tax allowance, let's say, to provide child care. So, I would like to confine my remarks to the child.
Senator GORE. Well, then, let's talk about children. The personal exemption for a taxpayer applies not only to himself but also to each of his dependents.
Senator NEUBERGER. Right.
Senator GORE. I have felt that people who need tax relief most of all are the parents with the most children.
Senator NEUBERGER. Well, isn't that taken care of by that $600 allowance for each child, I mean, isn't that the reason for it?
Senator GORE. That is the reason for it, but it seems to me that the most unrealistic provision of our tax law is the assumption that $600 is in some way a fair measure of the cost of rearing and educating a child.
Senator NEUBERGER. True.
Senator GORE. And I would like to increase that personal exemption, not only for the taxpayer, for the parent, but for each of the children of those parents.
Senator NEUBERGER. Well, you are so right, $600 is not at all realistic. But, of course, in my proposal, then you are just asking for a special deduction for the children of working mothers with low incomes, so we are confining it to a very special group that we think needs special help.
Senator GORE. I am sympathetic to your proposal, but it seems to me that parents, in general, compose a special group who are entitled to more equitable treatment than is the case under present law. I will

not ask you to take a position at this time on an amendment which I will later offer, but I solicit your consideration of an amendment which I intend to offer which will raise the exemption from Federal tax of a minimum amount of income for each taxpayer and each dependent of that taxpayer.

Senator NEUBERGER. Maybe we should collaborate on a bill to provide the family allowance program as they have in Canada. This really would take care of children. If you know of that plan they have, and I think it has a great deal of merit, but I just do not think we are quite ready for it yet, and my amendment is something to alleviate a bad situation.

But you know, up to now, whether a working mother had 1 child or 10, the maximum allowance she got for a child care was $600, and yet if you go to hire child care, put the child in a day nursery they do not give you a group rate and say, "We will take the whole group for $15 a week," it is so much a child and that is one of the most unrealistic things about our present child care deduction.

Senator GORE. I shall be happy to collaborate with you in looking to a possible joint amendment along this line.

The CHAIRMAN. Any further questions?

Thank you very much, Senator Neuberger.

The next witness is the Honorable Jack Miller, U.S. Senator from Iowa.

Take a seat, sir. We are very glad to have you, sir.

STATEMENT OF HON. JACK MILLER, A U.S. SENATOR FROM THE STATE OF IOWA

Senator MILLER. Thank you, Mr. Chairman. I appreciate the courtesy of giving me a few moments before this committee.

Mr. Chairman, there are two questions before this committee: (1) Whether or not there should be a tax cut; (2) to what extent there should be a tax cut without a reduction in Federal spending to make room for it?

So many persuasive arguments for a tax cut have been advanced by so many experts—Republican and Democratic alike— that I do not believe I need to dwell on the first question. Almost everyone is in agreement that there should be a tax cut.

It is over the second question that most of the argument is being waged—although I recognize that considerable disagreement exists over whether a tax cut——

Senator GORE. Mr. Chairman, before the Senator leaves that statement, "almost everyone is in agreement that there should be a tax cut," I thoroughly disagree with that. I talked to one Senator yesterday who told me he had visited in 50 counties in his State and asked this question in each of those 50 counties. He found only one man in the 50 counties who thought that the revenue of the Government should be reduced.

Senator MILLER. May I respectfully say to my friend that I believe that these questions are not phrased in a manner which gives a responsive answer. I have had a similar experience in the State of Iowa. In fact, I have only received two letters from all of the businessmen in the State of Iowa asking me to support a tax cut without a cutback in spending to make room for it.

But I believe that if the Senator would let me continue, I can cover this second point which will tie in with the experience he has found, because you have got to take this in the circumstances of whether or not we are going to have a tax cut in a setting of a cutback in spending and many people have a feeling that they should not have a tax cut in a setting without a cutback in spending.

Senator GORE. Well, the reason I interrupted——

Senator MILLER. May I say this, perhaps this will be responsive to the question? When we talk about tax reduction or a tax cut, I don't think we need necessarily confine ourselves to the narrow limits of a tax rate reduction, but I do believe it is generally agreed that there should be some kind of a tax reduction.

Now, whether that takes the form of an increase in exemptions or credits or deductions or reductions in tax rates is not terribly important to most taxpayers, but I do believe that most taxpayers would like to have a tax cut, and that a strong argument can be made for some kind of tax reduction.

Senator GORE. Well, if you want to modify the statement and say that there is general agreement that all of us would like our taxes cut, then I would agree with it.

Senator MILLER. That is exactly what this——

Senator GORE. But I don't believe your statement, standing alone, and it is a quotable sentence, quite represents the facts. I don't think—I think the American people reach their conclusions with respect to the circumstances as they are, not as they would hope them to be, and my experience in my own State, now buttressed by the experience of this Senator whom I will be glad to name privately to you, indicates that under the circumstances that prevail, the American people do not think it is either wise or sound to have a big tax cut.

Senator MILLER. May I say, Senator, I thoroughly agree with the latter part of your statement?

Senator GORE. Fine.

Senator MILLER. And I believe the balance of my statement will cover that.

Senator GORE. I hope you don't mind my interrupting you.

Senator MILLER. Now, it is over the second question that most of the argument is being waged—although I recognize that considerable disagreement exists over whether a tax cut should emphasize the consumer area of the investment and business area. The Chairman of the President's Council of Economic Advisers has been the principal spokesman for the consumer area approach. This position was rebutted by Roger A. Freeman of the Hoover Institute at Stanford University in his appearance before this committee on November 6. Personally, I believe that both areas should receive substantial attention.

The question of whether there should be a reduction in Federal spending to make room for a tax cut really resolves itself into a question of whether Congress is to provide a meaningful tax cut or a meaningless "teaser" which is calculated to cause the American taxpayer to think he can get something for nothing. What good will it do for a taxpayer who has $1,000 today with a purchasing power of $1,000 and tomorrow—after a tax cut—he can joyfully add up to $1,100 with a purchasing power still of only $1,000?

The inflation, or reduction in purchasing power of our dollar, which inevitably accompanies the deep, billion dollar deficits of our Government compels attention to this problem.

During 1961 and 1962 while we were going almost $14 billion deeper into debt, we had inflation of over $14 billion. It will be worse for this year inasmuch as we had $5.5 billion inflation for just the first 6 months of 1963. Based upon their respective shares of net national income, this has meant the equivalent of a 2, 3, and in some cases even 4 percent hidden sales tax on the backs of the people of the various States to pay for these deep deficits of their Federal Government.

I might add that these people are not impressed by the fact that the wholesale price index has remained stable. They happen to buy at retail. They are interested in the retail price index, which has been going steadily upward, while the purchasing power of their hard-earned money has been going steadily downward.

I recognize in an inflationary situation some people always benefit. I recognize without benefit of a tax cut there would be some taxpayers who would have more net purchasing power after the tax cut than they would before because they would have more dollars with more purchasing power to offset a loss in purchasing power with more of their dollars.

But there are millions of people who have little income or not enough income to pay an income tax and they would not receive any benefit whatsoever from an income tax cut but they would nevertheless feel the accompanying inflation.

Now, while debate goes back and forth over what expenditures are or are not "necessary" in the national interest. I don't want to see us remain on dead center in the matter of tax reduction. We can have a meaningful tax cut—a tax cut accompanied by a stable dollar, a tax cut without aggravating the Federal deficit. This can be done by having the tax cut apply only to the area of growth income. I call this approach incentive taxation of growth income—a kind of "have your cake and eat it" proposition, have your tax cut, and at the same time not go deeper into debt because of it.

This plan is incorporated in my amendment No. 311 It strikes the tax rate reduction portions of the bill and inserts a new title I called reduction of income tax rates on growth income.

The word "incentive" has usually been associated with tax reduction, either through outright tax reduction or through tax reform or both. I assume that the reduction will automatically be followed by an increase in economic growth but there is no guarantee that this will happen. Most of us would probably anticipate an overall growth in our economy if we had a tax reduction accompanied by stable purchasing power of our money.

However, there would probably be taxpayers who would happily enjoy the tax reduction without seeking to contribute to economic growth, and this is one of the defects inherent in the House-passed bill's tax rate reduction proposal.

Regardless of whether they contribute to economic growth, taxpayers are going to get a tax cut. Many of them you might say will have a tax cut without having earned it by contributing to an increase in our national economy.

Let me make it clear that I am sympathetic to the proposals of Congressmen Herlong and Baker for a gradual reduction in tax rates. However, it presupposes a stable purchasing power of our money, a condition that is exceedingly difficult, if not impossible to achieve during periods of deep deficits such as the one we seem to be headed for in fiscal 1964.

So, I suggest that we confine our tax cuts to the area of growth income, and to provide a real incentive I recommend that our tax rates be cut in half with respect to growth income.

In example 1 which is on the next to the last page of the materials that I have furnished the members of the committee, I have set forth three cases showing what such tax reduction would amount to. Using 1963 as the base year with the plan in effect commencing January 1, 1964, and a growth in income for the years 1964 and 1965. You may note on the first example of a taxpayer having a $10,000 adjusted gross income his tax at the current rates would be $1,108. In 1964 if this plan goes into effect, let's say he increases his income by $5,000. He has $5,000 growth income with an adjusted gross of $15,000. His tax under the old rate would be $2,304, and the increase over the previous year's tax attributable to that $5,000 income would be $1,196.

Under my plan that would be cut in half, so that his total tax under the new plan would be $1,706, and the same concept flows in the second and third examples.

The second example concentrating on a taxpayer with a lower amount of adjusted gross income and the third example in the case of a corporation.

It would seem that the prospect of paying tax at only one-half the regular rate on growth income would be a tremendous incentive for taxpayers to increase their productivity. Wasteful or marginal costs, which too often are tolerated because they are tax deductible would be avoided.

So would unnecessary or excessive travel and entertainment expenses because by incurring them taxpayers would only reduce their growth income and their tax reduction. Thus self-discipline is built into this plan.

Now, in a nutshell we have to define growth income, and I have taken the approach that this growth income should represent the fruits of capital and labor. I would propose that in addition to business and farming income, wages and salaries, rents, ordinary dividends, royalties and interest be specified as the only other type income which can be used in computing growth in adjusted gross income in the case of individuals or taxable income in the case of estates, trusts, and corporations.

To be realistic or to have a realistic measurement of growth income certain adjustments should be made; capital gains, for example, including capital dividends, may happen to be realized during the current taxable year but they usually include growth which has occurred prior to the current taxable year.

Moreover, they already receive special incentive tax treatment and I would, therefore, exclude them from the definition of growth income. Income from recovery of bad debts, prior taxes, and delinquency amounts has no particular relationship to growth for a particular year, and income tax due to improvement.

Income due to improvements by a lessee is more in the nature of a windfall. I would exclude these items. Income from illegal activity should be excluded for I presume we would not wish to encourage this kind of growth. A lump-sum payment received in the taxable year reflects services rendered over a period of several years and cannot be reasonably attributed in its entirety to growth during the taxable year. A ratable allocation to the current year under the option available to the taxpayer now in the present law should be the limit.

But to be fair there are other adjustments that should be made to eliminate deductions which are properly allowable for tax purposes but have no essential relationship to growth. Thus net operating loss carryover deductions or capital loss carryover deductions should be excluded and so should losses attributable to fire, flood, drought, windstorm, or other casualty not covered by insurance or otherwise.

Income covered by a mere change in the value of inventory or the method of accounting or the method of depreciation does not relate to economic growth and should be eliminated. Then, of course, there should be in the case of corporations a provision which would not discourage corporate giving. We would not want corporations to increase their growth income merely by reducing the amount of their charitable contributions.

I think that should be excluded. And, of course, a correlative series of adjustments should be provided for the base year as against the growth year.

Now, there are certain provisions that are necessary to prevent what I call windfalls, whipsawing, and other undesirable results starting on page 8 of my paper.

The question arises, for example, whether a taxpayer who becomes a wage earner, salaried person, or businesss operator for the first time should be permitted to treat any or all of his first year's income as growth income, and the answer would seem to be no. Birth of income is not the same as growth income, and a similar answer should apply in the case of the first year of operation of an estate, trust, or corporation.

Accordingly, I would define growth income in such a way as to require it to be measured against the first immediately preceding full taxable year, so that at least 1 full year's experience will be used as a basis for calculating growth.

But that first year's experience may represent a part-time or nominal activity. To prevent a windfall by using the income from such a year as a base, I would provide that the tax reduction from the special rates on growth income not be in excess of the amount of tax for the preceding taxable year. I have set forth an example of that example No. 3 in the outline I have given to the committee.

Deliberate whipsawing by taxpayers shoulld be avoided and perhaps this might well be done, by providing that where income or deductions have arbitrarily been shifted from 1 year to another by a taxpayer for no business purpose other than a reduction of taxes arising from the reduced rates on growth income, the Commissioner may make such adjustments as are necessary to protect the revenue.

The doctrine of business purpose is reasonably well settled by the tax law, regulations, and court decisions and such a provision should be unwelcome only to those who would seek to frustrate the purposes of the plan.

There is also a proposal for administrative efficiency on page 10 of my paper, in which I would suggest that in the case of individuals, tax reductions of less than $5 not be recognized, and in the case of corporations, under $15 not be recognized.

Many of these small wage increases result from a mere cost-of-living increase under escalation clauses which have no relationship to increased productivity and such a provision would minimize the number of these small reductions.

The major provision, to prevent whipsawing is what I call a payback provision, because while we are interested in stimulating growth income we are equally interested that once a taxpayer has grown that he not go backward, and so I have provided that where a taxpayer reduces or goes downhill in the following year, that he have to pay back a portion of his tax rate reduction—tax reduction for the year of growth. In other words, if a taxpayer grew from $50,000 to $60,000, let's say, a corporation, in 1 year, and then received his tax reduction for that growth, and then in the following year he went back downhill from $60,000, let's say, to $55,000, I would provide that he have to pay back one-half of the benefit he received from the previous year's growth.

Now, in conclusion, like many other plans of tax reform this one naturally has its minimum uses. I recognize that many taxpayers would not receive any benefit from it at all. Some are in a declining income position which is beyond their control. Others, including most Members of Congress are in a stable earnings position with little likelihood for improvement, although this plan will provide encouragement to make the most of opportunities for improvement.

However, similar criticism could be made of other tax reduction provisions now contained in the tax law. For example, faster depreciation methods and rates are meaningless to a taxpayer caught in the same tax bracket with or without them. Percentage depletion is meaningless to a taxpayer to the extent that it exceeds 50 percent of net income. The deduction for medical and hospital expenses means nothing to over half the taxpayers under 65 who either use the optional standard deduction or find such expenses exceeded by 3 percent of their adjusted gross income.

Nevertheless, these provisions have been enacted because Congress considered that on balance they were in the national interest. I might also point out that the major benefit of the investment tax credit which Congress passed last year will run to a relatively small number of taxpayers.

Incentive taxation of growth income is entirely workable and administratively feasible. It would be simple for most taxpayers to compute their tax reduction because they would have few, if any, adjustments to make. Corporations and individuals operating a business would in some cases find it complicated.

However, when we recall how complicated the excess profits tax law was perhaps we should not be too impatient with a far less complicated proposal which will, unlike the excess profits tax law, reduce taxes.

Mr. Chairman, I have a complete statement and I would ask permission that it be included in the record, along with an article from the Wall Street Journal of Tuesday, October 15, entitled, "Tax Incen-

tive to Spur Exports Is Weighed. Decision Isn't Likely Before the End of the Year."

This indicates that there is some thinking about incentives in the tax field.

The CHAIRMAN. Without objection.

Senator MILLER. If I may, I have two short technical suggestions to make.

The first one is that section 207 of the proposed bill would result in limiting the motor vehicle registration fee deduction to the portion of the fee based on the value of the automobile. In some States, including my own State of Iowa, this will mean that taxpayers would have to go to the trouble of computing the portion of their registration fee that is deductible and the portion that isn't—as far as their page 2 (form 1040) deductions are concerned. I strongly recommend that the entire motor vehicle registration fee be permitted to be deducted as it is now to prevent this complexity over what will amount to a very minor amount of tax money.

Second, where a farmer has his crop hailed out and receives hail insurance proceeds, the proceeds are treated as ordinary income—a sort of replacement for the crop income. There is no question but what this treatment is proper, but it can cause undue hardship by requiring a farmer to report the proceeds in the year of receipt (which usually is in the year the crop has been growing) rather than in the following year, when he would ordinarily sell his crop. Present tax law results in doubling up of income in 1 year. The law should be changed to give the farmer the option of reporting the proceeds in either the year of receipt or in the following year.

Mr. Chairman, that concludes my statement.

(The full statement of Senator Miller and the Wall Street Journal article referred to follow:)

STATEMENT OF HON. JACK MILLER, U.S. SENATOR FROM THE STATE OF IOWA, ON PLAN FOR "INCENTIVE TAXATION OF GROWTH INCOME"

Mr. Chairman and members of the committee, I appreciate very much your courtesy in granting me the opportunity of appearing here this morning.

At the outset, let me point out that I am a tax lawyer by profession. Since the end of World War II my time has largely been devoted to the tax field—on the Government side in the Office of the Chief Counsel of the Internal Revenue Service, in the classroom as a law teacher, in private tax practice, and as a legislator. I have given a great amount of time and consideration to the problems of tax reform and to the national concern over the adverse effect our system of income taxation has been having on our capitalistic economic system. The proposal I will outline before you is the best I have been able to devise.

As we go through this together, please remember that some of the points are subject to modification or even elimination. There may be some areas of oversight, although I have taken pains to draw a very tight plan. However, I suggest that differences over such matters can readily be resolved without impeding the effectiveness of the plan. It is the approach, more than anything else, that I request you to seriously consider.

Most of us would agree that tax reduction must be meaningful. If it is designed to remove impediments to economic growth it must furnish more purchasing power to consumers or more investing power to investors, or both. This should be in terms of real dollars—not dollars with reduced purchasing power due to inflation. People are asking, and rightly so, what good will it do to have additional purchasing power pumped into our economy by a $2.7 billion tax cut for fiscal 1964 if, at the same time, $2.7 billion in purchasing power is

drawn out of our economy as a result of inflation. And these people are concerned that a deficit of $10 or $12 billion for fiscal 1964 will be accompanied by $2.7 billion or more reduction in the purchasing power of our money. They are not without reason, for during the last 2 years our $14 billion increase in the national debt has been accompanied by over $14 billion in inflation.

The executive branch has told us that we have only one choice: Either we can choose to have a $9 billion deficit and no tax cut, or we can choose to have a $12 billion deficit and a tax cut. I submit that we don't have to make such a choice at all. We can, for example, choose to reduce expenditures; and there is good authority for the proposition that this will reduce the deficit. Those who argue that a reduction in expenditures will hurt the economy should be reminded that drawing upon the savings of our people to purchase Government bonds needed to finance deficit expenditures will hurt the economy by taking this much consumer and investor money out of circulation.

But while debate goes back and forth over what expenditures are or are not necessary to the national interest, I don't want to see us remain on dead center in this matter of tax reduction. There is another choice, and that choice is to have tax reduction without aggravating the deficit. This can be done by having the tax cut apply only to the area of growth income. I call this approach incentive taxation of growth income. It is a kind of "have your cake and eat it" proposition. Have your tax cut and, at the same time, not go deeper into debt because of it.

The word "incentive" has usually been associated with tax reduction—either through outright tax rate reduction or through tax reform, or both. I assume that the reduction will automatically be followed by an increase in economic growth, but there is no guarantee that this will happen. Most of us would probably anticipate an overall growth in our economy if we had tax reduction accompanied by stable purchasing power of our money. However, there would probably be taxpayers who would happily enjoy the tax reduction without seeking to contribute to economic growth.

Let me make it clear that I am in sympathy with the proposal of Congressmen Herlong and Baker for a gradual reduction in tax rates. However, it presupposes a stable purchasing power of our money—a condition that is exceedingly difficult if not impossible to achieve during periods of deep deficits, such as the one we seem to be headed for in fiscal 1964.

And so I suggest that we confine our tax cuts to the area of growth income; and to provide a real incentive, recommend that our tax rates be cut in half with respect to growth income. In example 1 I have set forth three cases showing that such tax reduction would amount to, using 1963 as the base year, with the plan in effect commencing January 1, 1964 and a growth in income for the years 1964 and 1965.

It would seem that the prospect of paying tax at only one-half the regular rate on growth income would be a tremendous incentive for taxpayers to increase their productivity. Wasteful or marginal costs, which too often are tolerated because they are tax deductible, would be avoided. So would unnecessary or excessive travel and entertainment expenses, because by incurring them taxpayers would only reduce their growth income and their tax reduction. Thus, self-discipline is built into the plan.

"GROWTH INCOME" DEFINED

The definition of "growth income" must be precise and realistic. It should certainly include business and farming income. With respect to other items of income, either of two approaches may be used. One approach, which is simpler, would be to specify the items. The other approach would be to include all income except certain items which do not have any particular relevance to growth during the current year due to the taxpayer's labor or capital. For example: pensions and annuities, income in respect of a decedent, income from death benefits, compensation from injuries, income from an estate or trust, alimony and separate maintenance benefits, income from the discharge of indebtedness, and the like. Even with these exclusions, however, we would still be faced with situations under which an incentive would be extended to increase income that would be of marginal or questionable significance insofar as labor or capital are concerned, not to mention illegal income, which is nonetheless taxable.

Accordingly, I would propose that in addition to business and farming income, wages and salaries, rents, ordinary dividends, royalties, and interest be specified as the only other type income which can be used in computing growth in adjusted gross income (in the case of individuals) or taxable income (in the case of estates, trusts, and corporations). These items constitute the major sources of income of the vast majority of taxpayers and are relatively easy to ascertain; and from the standpoint of administration, it is desirable to keep them at a minimum. Moreover, all of them have a clear connection with the utilization of labor or capital in the production of income.

To have a realistic measurement of growth in income, certain adjustments should be made.

Capital gains, including capital dividends, may happen to be realized during the current taxable year, but they usually include growth which has occurred prior to the current taxable year. Moreover, they already receive special incentive tax treatment. I would therefore exclude them from the definition of growth income.

Income from recovery of bad debts, prior taxes, and delinquency amounts has no particular relationship to growth for a particular year; and income due to improvements by a lessee is more in the nature of a windfall. I would exclude these items.

Income from illegal activities should be excluded, for I presume we would not wish to encourage this kind of growth.

A lump-sum payment received in the taxable year reflects services rendered over a period of several years and cannot be reasonably attributed, in its entirety, to growth during the taxable year. A ratable allocation to the current year under the option available to the taxpayer should be the limit.

To be fair, there are other adjustments that should be made to eliminate deductions which are properly allowable for tax purposes but have no essential relationship to growth. Thus, net operating loss carryover deductions or capital loss carryover deductions should be excluded; and so should losses attributable to fire, flood, drought, windstorm, theft, or other casualty not covered by insurance or otherwise.

Income resulting from a change in method of valuing inventory, method of accounting, or method of depreciation does not relate to economic growth and should be eliminated.

To prevent the use of a controlled corporation as a device for abnormally increasing the dividend income of its stockholders, I would suggest that dividend income in excess of 125 percent of such income received from the corporation in the previous taxable year, or in excess of current earnings of the corporation, whichever is the greater, be excluded. Control should be determined by constructive ownership under section 318.

And to prevent the use of a controlled corporation as a device for shifting income to its stockholders, I would suggest exclusion from the computation of growth income of income from a business or partnership which represents the continuation of the business of such a corporation. However, I would not have this provision apply after the first full taxable year following the cessation of such business by the corporation.

A similar exclusion of income of a corporation which represents the continuation of the business of its controlled corporation should be made.

Another adjustment appears desirable in the case of corporations. Contributions to charitable, educational, religious, scientific, and similar activities are becoming increasingly important and are to be encouraged. If a corporation's growth income could be enhanced merely by cutting back its contributions, a long-standing policy of Congress to encourage corporate giving would be frustrated. Accordingly, it appears desirable to provide that growth income of a corporation may not be so achieved.

Finally, in the case of estates and trusts, we should not permit growth income to be achieved by merely decreasing the payments to beneficiaries where such payments are discretionary.

So much for adjustments to the year of growth. What about adjustments to the preceding taxable year—the base year against which the growth is measured?

It would be my recommendation to make similar adjustments for capital gains and losses, the capital loss carryover deduction, not operating loss carryover deduction, income from recovery of bad debts, etc., improvements by a lessee, and casualty losses. I would also adjust out the additional first-year depreciation deduction, because this would otherwise give rise to an artificially low base year and lay a foundation for an artificially large amount of growth in the following year. I am also dubious over permitting a lowering of the base year's income by eliminating income arising from a change in method of valuing inventory, change in method of accounting, or change in method of depreciation. Such changes are usually voluntary on the taxpayer's part and often are made with a view to improving his tax position. Accordingly, I would propose that a lowering of the base year's income by eliminating such income be permitted only where the change in method has been forced on the taxpayer by the Government.

PREVENTION OF WINDFALLS, WHIPSAWING, AND OTHER UNDESIRABLE RESULTS

In order to prevent windfalls, whipsawing (fluctuating income from 1 year to another to take undue advantage of the reduced rates on growth income), and other undesirable results, certain provisions are necessary.

The question arises whether a taxpayer who becomes a wage earner, salaried person, or business operator for the first time should be permitted to treat any or all of his first year's income as growth income. The answer would seem to be "No." Birth of income is not the same as growth in income. A similar answer should apply in the case of the first year of operation of an estate, trust, or corporation. Accordingly, I would define growth income in such a way as to require it to be measured against the first immediately preceding full taxable year, so that at least 1 full year's experience will be used as a basis for calculating growth. But that first year's experience may represent only part-time or nominal activity. To prevent a windfall by using the income from such a year as a base, I would provide that the tax reduction from the special rates on growth income not be in excess of the amount of tax for the preceding year. Example 2 illustrates the application of this provision.

Deliberate whipsawing by taxpayers may possibly be attempted notwithstanding the precautionary provisions built into this plan. With a view to discouraging such efforts, it would seem proper to provide that where income or deductions have arbitrarily been shifted from 1 year to another by a taxpayer for no business purpose other than reduction of taxes arising from the reduced rates on growth income, the Commissioner may make such adjustments as are necessary to protect the revenue. The doctrine of "business purpose" is reasonably well settled by the tax law, regulations, and court decisions, and such a provision should be unwelcome only to those who would seek to frustrate the purposes of the plan.

Where a joint return is filed for the current taxable year, it would be unrealistic to measure the income reported against the income of only one of the spouses for the preceding year if separate returns were filed by them—either as married or single persons—unless the income on the joint return represents the actual income of only one of them. I use the word "actual" to make it clear that community property law will not enter into this calculation.

With the "payback" provision, which I shall presently discuss, the graduated tax rates applicable to individuals, trusts, and estates do not offer much opportunity for whipsawing. There is, however, some opportunity for whipsawing in the case of corporations. To discourage this, I would propose using as a base year the immediately preceding full taxable year—as in the case of individuals, estates, and trusts—with the limitation that the taxable income for such base year be not less than the taxable income for fiscal or calendar year 1963. If the corporation was not in existence or active during fiscal or calendar year 1963, its first full taxable year would be used for this purpose. However, one can conceive of situations where a corporation's taxable income for fiscal or calendar year 1963 might be abnormally high, leaving little or no incentive to the corporation to seek growth because of the arbitrary selection by Congress of the taxable income of such year as a limitation on the base year. To cover these situations, I would propose that in lieu of fiscal or calendar year 1963, a cor-

poration could elect to use—as a limitation against the taxable income of the base year—the average taxable income of fiscal or calendar 1963 and the two preceding taxable years—or the preceding taxable year, if the corporation was not in existence or active during the 2 years preceding fiscal or calendar 1963. Example 3 illustrates the application of this provision. A similar provision should be made with respect to a continuing corporation following a reorganization, using the combined incomes of the parties to the reorganization in computing the base year income.

To avoid the administrative burden that would arise from numerous small tax reductions due to minor increases in income, I would suggest that in the case of individuals, tax reductions of less than $5 not be recognized; and in the case of corporations, tax reductions of less than $15 not be considered. I might point out that a good many small wage increases result from mere cost-of-living increases under escalation clauses, which do not relate to increased productivity, and such a provision as I have suggested would minimize the number of these that would lead to small tax reductions.

TAX REDUCTION "PAYBACK"

Not only do we wish to encourage growth. We wish to discourage going backwards after growth. Such a policy, coupled with a policy against whipsawing, prompts me to recommend what I call a "tax reduction payback" provision. It would require the voiding of a tax reduction based on growth income if, in the following year, the taxpayer's income decreases. The tax reduction would be voided according to the proportion that the decrease bears to the amount of growth income on the basis of which the tax reduction was computed. Examples 4 and 5 illustrate the application of the payback provision in the case of a corporation. Suitable provision should be made to prevent hardship due to a short year following the year of tax reduction where an estate or trust is terminated or where a corporation is liquidated, dissolved, or reorganized. I would suggest that income for the short year be annualized to determine whether there was any decrease which would require a payback.

The application of the payback principle should also be softened where a decline in income in the following year has been caused by losses due to fire, flood, drought, windstorm, theft, or other casualty, not covered by insurance; and, in the case of individuals, where it has resulted from the retirement or death of a taxpayer.

I would suggest that the amount of the tax reduction payback become a part of the tax due and payable for the year of the decrease in income, without interest.

CONCLUSION

Like any other major plan of tax reform, this one has its minuses. I recognize that many taxpayers would not receive any benefit from it. Some are in a declining position which is beyond their control. Others—including most Members of Congress—are on a stable earnings basis with little likelihood for improvement—although this plan will provide encouragement to make the most of opportunities for improvement. However, similar criticism could be made of other tax reduction provisions in the tax law. For example, faster depreciation methods and rates are meaningless to a taxpayer caught in the same tax bracket with or without them. Percentage depletion is meaningless to a taxpayer to the extent that it exceeds 50 percent of net income. The deduction for medical and hospital expenses means nothing to over half the taxpayers under 65, who either use the optional standard deduction or find such expenses exceeded by 3 percent of their adjusted gross income. Nevertheless, these have been enacted because Congress considered that, on balance, they were in the national interest. I might also point out that the major benefit of the investment tax credit which Congress passed last year will run to a relatively small number of taxpayers.

Incentive taxation of growth income is entirely workable and administratively feasible. It would be simple for most taxpayers to compute their tax reduction because they would have few if any adjustments to make. Corporations and individuals operating a business would, in some cases, find it complicated. However, when we recall how complicated the excess profits tax law was, perhaps we should not be too impatient with a far less complicated proposal which will, unlike the excess profits tax law, reduce taxes.

Examples of application of Miller plan for incentive taxation of growth income

1. Examples of tax reduction, assuming plan effective January 1, 1964. 1963 is the "base year" and growth occurs in 1964 and 1965.

	Adjusted gross income	Tax at old rate	Increase in tax over prior year at regular rate	Tax reduction ½ increase	New tax
Individual, married, 4 children, using optional standard deduction, with adjusted gross income from a salary, wages, profession, or business:					
1963	$10,000	$1,108	(1)	(1)	(1)
1964	15,000	2,304	$1,196	$598	$1,706
1965	20,000	3,740	1,436	718	3,022
Individual, married, 2 children, using optional standard deduction, with adjusted gross income from a salary, wages, profession of business:					
1963	5,000	420	(1)	(1)	(1)
1964	5,500	510	90	45	465
1965	6,000	600	90	45	555
Corporation, taxable income as shown in 2d column (note first $25,000 taxes at 30 percent; all over $25,000 taxed at 52 percent):					
1963	100,000	46,500	(1)	(1)	(1)
1964	120,000	56,900	10,400	5,200	51,700
1965	140,000	67,300	10,400	5,200	62,100

[1] Change not in effect.

2. Example of limiting amount of tax reduction in growth year to amount of tax for preceding year to prevent windfalls.

B, a college senior, graduates in midyear and commences full employment, earning $5,000, with regular tax thereon of $813. During the preceding year he worked part time, earning $1,200 and paying tax of $98. His tax reduction for the current year would be only $98—not $357.50 (one-half the difference between $813 and $98).

3. Example of elective provision in case of corporation. Average taxable income for 1961, 1962, and 1963, used in lieu of taxable income for 1963 "base year."

Corporation X had taxable income as follows: (1961) $75,000; (1962) $100,000; (1963) $200,000; (1964) $100,000; (1965) $150,000. No adjustments were required to taxable income for 1964 and 1965. Obviously, there was no growth income for 1964 and no tax reduction. Growth income for 1965 cannot be measured against taxable income of $100,000 for 1964, because 1964 taxable income cannot be less than the $200,000 taxable income for 1963. However, the corporation elects to take the average taxable income for 1961, 1962, and 1963, which is $125,000, as the limitation below which base income for 1963 cannot go. Growth income for 1965 would be $25,000.

4. Example of "payback" provision. Two corporations, one with level income and the other with fluctuating income; 1963 is "base year."

Corporation A has taxable income (adjusted) of $100,000 for 1963, $100,000 for $1964, and $100,000 for 1965. It pays $46,500 tax for each year. It has no tax reduction for 1964 and 1965 because there is no growth income. On $200,000 combined income for 1964 and 1965 its combined tax is $93,000.

Corporation B has taxable income (adjusted) of $100,000 for 1963, $150,000 for 1964, and $50,000 for 1965. Its combined income for 1964 and 1965 is $200,000, and its combined tax is $93,000—the same as corporation A, computed as follows:

	1964	1965	Total
Taxable income	$150,000	$50,000	$200,000
Tax	72,500	20,500	93,000
Tax reduction	−13,000		
Tax reduction payback		+13,000	

5. Example of "payback" provision. Corporation B's taxable income (adjusted) for 1965 drops to $125,000 instead of $50,000 as above. In other words, while there was "growth income" of $50,000 in 1964 (from $100,000 in 1963 to $150,000 in 1964), half of the growth was "lost" in 1965. Accordingly, there will be a "payback" of half the tax cut for 1964, or $6,500 (one-half of $13,000 tax reduction for 1964).

[From the Wall Street Journal, Oct. 15, 1963]

Tax Incentive To Spur Exports Is Weighed; Decision Isn't Likely Before Next Year

(By Richard F. Jenssen, staff reporter of the Wall Street Journal)

Washington.—The Kennedy administration is hopefully but warily studying the idea of a tax incentive to boost exports.

The plan was broached by business leaders at last month's White House Conference on Export Expansion. Officials currently say it's unlikely they will reach a decision on it before early next year. This is partly because they want to see if exports of manufactured goods in the rest of 1963 perk up of their own accord; and they know that weary congressional tax writers have neither the time nor the desire to take on any more major projects this year.

While some major drawbacks are showing up, officials close to the plan say odds are still fairly good that the administration will endorse it. In large measure, they base their feelings on what they consider the very poor prospects that a more attractive way to fight the balance-of-payments deficit will pop up in the meantime.

Details are far from ready. But basically, the idea would be to reduce a company's income tax by, say, 10 percent of the amount its exports rose from a base period. A company boosting its exports by $1 million, for instance, would have the tax due on its profits from domestic and export income reduced by $100,000.

ADMINISTRATION EAGER

The administration is clearly eager to do whatever it can to boost exports. The United States already sells about $4 billion more goods abroad each year than it buys, but dollar outflows for such things as keeping troops overseas, foreign aid, and private investment more than wipe out this surplus. This piles up dollars in foreign central banks, which can be used to buy gold from the dwindling U.S. stock.

Because the administration is loath to cut outlays abroad in ways it fears would jeopardize national security, and has proposed a new tax to reduce the flow of private investment dollars overseas, a tax spur to exports is the next most likely move, supporters of the plan reason. "We're already doing all the easy things, and now we're down to the hard ones—no matter what's proposed lately, somebody blanches and runs screaming out of the room," one official observes.

A possibly decisive argument in favor of the tax lure is that it is "expansionist." It would tend to expand world trade and boost sales and profits of U.S. companies, proponents say, while most of the other steps the administration could still take are "restrictionist" in that they would hamper U.S. and world business. Naturally, an administration facing reelection in about a year is reluctant to impose tough restrictions on what Americans can import or clamp direct controls on U.S. private investment abroad.

The tax plan could have some positive political benefits, too. It was proposed by a committee of businessmen, including high officials of such big companies as Westinghouse Electric Corp., International Harvester Co., Sears, Roebuck & Co., and Lockheed Aircraft Corp. An administration viewed suspiciously as "antibusiness" by many executives could find it most difficult to turn down a plan it basically wants and which it expects businessmen would "greet with hallelujahs," one proponent says.

Perhaps the most worrisome question being studied by a task force of Commerce Department specialists is whether any "reasonable" amount of tax credit would really be enough to make businessmen push exports much harder. If they come up with projections that it would be worthwhile, the plan appears sure to get Commerce Secretary Hodges' support; strongest sentiment in the Government for the plan now centers in the Commerce Department. President

Kennedy has at least shown favor to study of the tax plan, and has made very clear his desire to see exports climb.

Possible revenue loss isn't being overlooked, though, especially in the Treasury. Tax planners are chilled by the prospect of giving the credit to some companies that probably would have boosted their exports even without it, and complain it wouldn't be fair to companies that do well if they just hold their own against mounting foreign competition. The tax men also are already beginning to worry that some companies might try to take unfair advantage by forming new corporations to handle their exports, thus getting a low or even "zero" base and a big tax credit for their fast export "improvement."

"But if you formulate the credit to avoid all the loopholes and inequities," one tax technician says, "you make it so complex that you lose much of the effectiveness. Some companies will figure that it'll take 5 years of wrangling and redtape to get their credit, and decide it wasn't worth it."

OTHER NATIONS' REACTIONS

Officials will be sampling the reaction of other nations, too. An immediate problem is that the General Agreement on Tariffs and Trade, of which the United States is a party, outlaws income tax rebates as an export spur. But it does allow nations to rebate manufacturers' sales taxes on goods to be exported, Its theory is that sales taxes paid by manufacturers are really borne by consumers through higher prices and that the manufacturers shouldn't have to shoulder them for goods that leave the country. This theory also holds that companies don't adjust their prices to cover income taxes, and because they don't, there are no grounds for allowing them to be rebated on exports.

U.S. officials would have to argue that in modern practice companies do take income taxes into account in pricing their products and that the consumer ultimately pays them just as he does the factory sales taxes. Commerce men hope they can persuade GATT nations to allow a "temporary" U.S. income tax credit, but Treasury men are more worried about "retaliation." European nations say that their sales taxes are only a supplement to the corporate income taxes their businesses pay, too, and that "if the United States opens a new hole, they might want to crawl through it, too."

The CHAIRMAN. Thank you very much, Senator Miller.

The committee will give full consideration, sir, to your suggestion. Any questions?

The next witness is Mr. David W. Herrmann, National Association of Shoe Chain Stores. Take a seat, sir.

STATEMENT OF DAVID W. HERRMANN, ON BEHALF OF NATIONAL ASSOCIATION OF SHOE CHAIN STORES

Mr. HERRMANN. Mr. Chairman, may I have Mr. Atkins with me in case I don't hear any other questions as the result of a slight hearing deficiency, please. He is executive vice president of the National Association of Shoe Chain Stores and he is here for the purpose of helping me out on any questions that I may not be able to hear from the Chair.

Mr. Chairman and members of the Senate Finance Committee, my name is David W. Herrmann. I am appearing here in behalf of the National Association of Shoe Chain Stores, and as chairman of its committee on taxation.

The National Association of Shoe Chain Stores represents more than 8,000 stores, located throughout the United States and its possessions, which stores sell, primarily, popular priced footwear, and have on their payrolls approximately 30,000 employees.

Until July 1962, I was executive vice president of the Melville Shoe Corp., and since that time have been a consultant to this company, and to others.

My interest is that of a businessman, familiar with the history of section 1551 of the 1954 Tax Code, and its benefits to our economy over a period of 12 years since its enactment in 1951 as section 15(c).

My interest is further motivated by a sincere belief that multiple surtax exemptions for groups of small related corporations are justified as a matter of equity and good economics, without being prejudicial to any other segments of business, large or small, and without conveying to such related group any special privilege.

I believe that section 1551, enacted to prohibit splitups, but to encourage expansion, has consistently attained the objectives for which it was designed, and should be continued without change.

We are, therefore, requesting the following three amendments to H.R. 8363:

1. The elimination of the 6-percent penalty, as opposed to the intent of existing statutes, and contrary to the commendable objectives of the late President Kennedy's message of January 24, 1963,

> * * * to step up the growth and vigor of our national economy—to increase job and investment opportunities—to improve our productivity * * *.

2. A 100-percent exclusion of intercorporate dividends received, thereby eliminating the intercorporate dividend tax which, in effect, constitutes a triple tax on earnings accruing to stockholders.

3. The elimination of the word "indirectly," introduced as an amendment to section 1551, or a specific clarification in the text that will not prohibit expansion.

I will, therefore, address myself initially to section 223 in the House bill, relating to multiple surtax exemptions.

The Ways and Means Committee, under the respected chairmanship of the Honorable Wilbur D. Mills, affirmed the validity of multiple surtax exemptions under certain circumstances.

Nevertheless, House bill H.R. 8363 provides that, in the event the members of a controlled group of corporations elect to file separate tax returns, there shall be imposed on the taxable income of each corporation a penalty tax equal to 6 percent of such corporation's taxable income, for each taxable year, as does not exceed $25,000.

The present intercorporate dividend tax, equivalent to over 5 percent on subsidiary income, together with the aforementioned 6 percent penalty, create an effective tax rate for subsidiaries in excess of 33 percent, or 11 percent above the proposed normal rate of 22 percent. On subsidiary income over $25,000 transfer as dividends the rate would be 53 percent; a penalty on progress, on growth and on expansion would retard rather than stimulate our economy.

In "Summaries of Tax Bill Provisions," dated September 1, 1963, under the section entitled, "Multiple Surtax Exemptions," Treasury has stated that—

> Despite clear congressional intent underlying the surtax exemptions, its benefits have not been confined to small business.

This is, obviously, a misconception as to congressional intent, hereinafter quoted.

Section 1551 was not designed for the exclusive benefit of small business, or any other category of business, although small business did benefit tremendously from its provisions. Section 1551 was a

studiously considered piece of reform legislation which, in effect, prohibited splitups but, to quote:

* * * does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations as distinguished from a mere splitup of an existing business * * *.

Clearly, Congress intended to make surtax exemptions available to related corporations in situations involving expansion.

Since 1951, there have been no significant splitups of record. Such splitups, eligible for surtax exemptions, could not, and cannot, occur without being in flagrant violation of section 269, reinforced to the hilt by section 1551. It must be assumed that the Internal Revenue Service would be alert to correct any attempted violation.

The report of the Ways and Means Committee on H.R. 8363, under the heading, "Deduction of Surtax Exemption in the Case of Certain Controlled Corporations," states.

While your committee recognizes the importance to small business of reducing the tax on the first $25,000 of income from 30 to 23 percent, it also recognizes that this substantial tax reduction should not provide added inducement to existing medium and large corporations to split up into multiple corporations.

On page 118 of the aforementioned report, the committee also states:

* * * there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, your committee does not intend to encourage the formation of these multiple corporations and therefore proposes to apply higher tax rates to corporations which are members of an affiliated group of corporations.

Secretary Dillon reaffirmed this in his testimony before the Finance Committee.

Respectfully, I must state that these statements, inherently, constitute a contradiction difficult for me to understand. The validity, legitimacy, and advantages to our economy of separate corporations entitled to multiple surtax exemptions, are recognized by the committee and, in the same paragraph, it is stated that the further formation of such corporations should not be encouraged.

The Treasury Department, in its "Summaries of Tax Bill Provisions," page 30, states:

The present law provides incentive for deliberate abuses through proliferation of corporation units.

Treasury has, in its "Summaries," avoided any reference to expansion, and has consistently used the term, "proliferation," which might have negative implications.

Section 1551 has encouraged expansion, both in the case of medium-sized corporations operating small specialty stores, and individually owned small corporations initially operating one or more specialty stores of comparable size, character, and type.

This legislation, designed to encourage expansion through the "proliferation" of additional establishments or enterprises, is beneficial to our economy. All types of business—large, small, and medium—inevitably benefit as a result of this type of legitimate "proliferation," which should be further encouraged, not discouraged.

It is my considered judgment, that of many businessmen and undoubtedly that of this committee in 1951 in enacting legislation which resulted in section 1551, that multiple surtax exemptions to encourage

expansion, result in greater taxable revenue to the Government rather than less. They create the incentive and the available after-tax earnings that are appropriated for further expansion. Many other dependent industries benefit proportionately from such expansion and, conversely, would suffer from any cutback.

Exhibit 13, entitled, "Multiple Incorporation," and labeled "Present Abuses—Multiple Incorporation Cases," page 206 of the "Hearings Before the Committee on Finance, U.S. Senate, 88th Congress, 1st Session," illustrates the insignificant and inconsequential effect of multiple surtax exemptions on tax revenue.

Although the Treasury states that the cases submitted, * * * are not the result of an exhaustive search for all such cases which may exist," it may be reasonably assumed that the examples selected for the exhibit constitute a major portion of the significant situations in which there are related corporate taxpayers.

It is safe to assume they put their best foot forward.

Actually, the subsidiaries—parent and brother-sister types—included in the exhibit, are small corporations, earning far less than the $25,000 specified for the surtax exemption. They are relatively low volume, low profit, corporations with average taxable income of approximately $11,000 per subsidiary, according to the figures contained in the exhibit.

The imposition of the 6-percent penalty, on the normal tax of the 4,977 corporations constituting the examples, would result in additional tax revenue of only $3,300,000. If Treasury's estimate of $35 million of additional tax revenue, to be derived from the imposition of this 6-percent penalty on the income of related corporations is correct, and not overly optimistic, then the remaining $31,700,000 of such estimated revenue would probably be derived from small business, perhaps operating in related groups of two or three separately incorporated stores. Undoubtedly, the penalty would constitute an impediment to their further growth and expansion, and adversely affect their competitive position.

The expansion which, though the foresight of Congress, was fostered in 1951, with the enactment of section 15(c), incorporated into the1954 Tax Code as section 1551, has been a stimulant to our economy, and of equal benefit to small business.

The intention of the conferees was clearly stated in the "Summary of the Provisions of the Revenue Act of 1951 (H.R. 4473) As Agreed to by Conferees—Prepared by the Staff of the Joint Committee on Internal Revenue Taxation," and reads as follows:

> This provision of the bill does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations, as distinguished from the mere splitup of an existing business nor does it prevent an individual or group of individuals who may own the stock of a corporation from forming additional corporations to engage in a similar or a different business.
>
> A corporation wishing to expand its activities may use a part of its funds, whether or not those funds represent accumulated earnings, to form the capital of a new corporation, acquiring the stock of the new corporation in exchange for those funds. Or an individual who owns all the stock of a corporation may use any cash or property he owns to form a new corporation. In such cases the new corporation will be allowed the full surtax exemption and the minimum excess profits credit.

It is apparent from the aforementioned statement, that Congress intended that a new establishment, conducted in a related group,

would be entitled to its own surtax exemption, and that this would not be regarded as a device for the purpose of obtaining an additional surtax exemption for the parents corporation, nor was there any declaration of intention to confine the provisions of this section to any size of business—large, medium, or small.

Corporations, organized in accordance with the provisions of section 1551, do not constitute an "abuse," as improperly labeled by Treasury in the title of exhibits entitled, "Multiple Incorporation Cases." These types of relatively low volume, low profit specialty stores, whether members of a small- or medium-sized group of related corporations, have spearheaded one of the greatest programs of expansion in the history of the retail industry.

Since 1951, there has been a radical and rapid transition in patterns of distribution. Population growth, traffic, and parking problems have motivated a diversion and shift from urban locations to suburban shopping centers. Most of these shopping centers could never have been organized without a nucleus of small specialty stores operated by chain organizations, encouraged and assisted in a program of expansion by the after-tax earnings resulting from multiple surtax exemptions.

The leases of these types of corporations were required by banking institutions and insurance companies to be deposited as collateral for the financing of these shopping centers. They enabled the organizers and landlords of these centers to provide adequate facilities for individual local merchants, for which space has always been provided.

These additional facilities enabled local merchants to survive the shift from urban areas. These additional stores were eligible for surtax exemptions, without a penalty on progress.

These centers could never have obtained adequate financing based solely on the leases of the large million dollar units—department stores, large variety chains, and supermarkets, at rental figures that represented or almost represented subsidies by landlords, essential to attract specialty stores and other tenants at higher rentals.

Secretary Dillon, in submitting exhibit 13 entitled Multiple Incorporation Cases, referred to four large retail organizations, which operate thousands of stores, "without the use of a highly proliferated corporate organization." The illustrations selected were J. C. Penny Co., Montgomery Ward & Co., the Kroger Co., and the Great Atlantic & Pacific Tea Co., Inc.—all corporations listed as members of the "Billion Dollar Club," in the March 6, 1963, issue of Investor's Reader, published by Merrill Lynch, Pierce, Fenner & Smith.

For the year 1962, Montgomery Ward & Co., with the lowest volume in this group, still achieved approximately 7½ times the sales volume of the largest retail shoe chain in the United States. The Great Atlantic & Pacific Tea Co., Inc., with the highest volume, achieved 30 times the sales volume of the largest retail shoe chain in the United States.

Various types of business organizations have different policies of operation. Many, for sound economic reasons, find it advantageous to operate their store units in a single parent rather than in related, in a related group and I assume the above corporations were in that category.

Related corporations, entitled to surtax exemptions, never had an effective rate as low as individually owned corporations. Under pres-

ent rates, the tax on intercorporate dividends results in an additional tax of 5.4 percent on subsidiary taxable income transferred to the parent. The transfer of subsidiary earnings, by the dividend route to the parent, is essential to provide funds for expansion and available cash for dividends to stockholders.

The proposed penalty of 6 percent on the income of a parent-controlled related corporation, together with an intercorporate dividend tax at proposed rates, will create an effective rate of 33 percent on subsidiary income alone, 11 percent more than paid by the individually-owned corporation on taxable income up to $25,000. Such a penalty is inequitable and inordinately excessive.

In Treasury's exhibit 13, and these statistics, Senators, are important, "Examples of Actual Multiple Incorporation Cases," the taxable income of all the companies listed totals $277,313,000. Under present rates, their total taxes were computed at $132,140,000, for an actual effective tax rate of 47.6 percent. It is apparent that these corporations have a tax rate considerably closer to the top normal and surtax rate of 52 percent; that the preponderant portion of their taxable income is at top rates—a considerably smaller portion of their taxable income subject to surtax exemptions.

It is also important to note that, in accordance with the calculations contained in Treasury's exhibit 13, even at the proposed new normal rate of 22 percent, without the imposition of any penalty such as 6 percent or any other percentage, the total taxes of all of the companies listed would result in an actual rate of 43 percent, preponderantly closer to the top normal and surtax rate of 48 percent.

There is a definite reason for this—many of these corporations organized their subsidiaries for purposes of expansion since 1951, as Congress intended, in acordance with "The Summary of the Provisions of the Revenue Act of 1951, as agreed to by the Conferees." Those that did not operate sub-subsidiaries before 1951 were, subsequently, prevented from splitting up thereafter, and the major portion of their profits remain subject to full normal and surtax rates, as indicated in the total of Treasury's aforementioned exhibit.

If lower corporate tax rates are intended to help small business, and stimulate our economy, there is no economic justification for denying these same lower tax rates to all corporations, without the imposition of a nullifying penalty together with the intercorporate dividend tax of 11 percent. To the best of my knowledge and belief, Congress has never adopted a tax law designed to keep small business small; to confine a corporate owner to one establishment; to penalize him if he wants to grow and open one more, two more, or many more.

Establishments of comparable size, volume and comparable low profits, should be enabled to compete with each other, and some of them should not be handicapped by the imposition of tax rates higher than their competitors.

Organizations, many of which are the backbone of our retail economy, have spent millions of dollars on expansion since 1951, in full reliance on section 1551. They now find themselves confronted with a penalty on the income of all corporations organized since that date, and that they no longer will be accorded the same tax rates as their competitors operating individually owned stores of comparable size and type.

There has been considerable testimony about the intent to help small business, despite the fact that the proposed penalty of 6 per-

cent will have just the opposite effect, and will tend to keep small business small.

Unfortunately, nothing has been said in any of the record that I can determine, about the small stockholder of the public corporations whose historical earnings since 1951 have been predicated on tax rates resulting from income eligible for surtax exemptions. Income available for a continuity of dividends to these stockholders will be seriously impaired by the imposition of the 6-percent penalty. These stockholders are essentially small investors, dependent on dividend income, and their expendable income is vital to stimulating the economy.

The largest chainstore organization in the shoe industry has approximately 30,000 stockholders, who average a little less than 93 shares each. The actual value of these shares is approximately $1,500 for the total 93 shares. These are small investors, just as much in need of consideration by the Treasury as the many thousands of independent small owners of retail stores.

Many publicly owned chainstore organizations are, in essence, no different than small independents in respect to effectual ownership. They operate groups of small business establishments, in behalf of thousands of small stockholders who should not be penalized after they have invested their money in reliance on after-tax earnings resulting from corporations organized in accordance with section 1551 of the code.

I am submitting some statistics which are almost self-explanatory.

The "10th Annual Operations Study of Family Shoestores in United States," was conducted by the School of Business and Public Administration, Washington University, St. Louis, Mo., in cooperation with the National Shoe Retailers Association, under a grant from "Footwear News." The statistics are being submitted for your information and for the record.

Samples drawn from all sections of the country, all sizes of towns and cities, included several hundred stores, the exact number not specifically stated. This study indicated the following statistics:

As percent of total shoe store sales

	1939	1948	1958
Single stores	36.2	42.0	41.5
2 and 3 stores	9.1	10.2	10.3
4 or more stores	54.7	47.7	48.1

The above statistics do not indicate any loss of position by single-store operators in the shoe field. In fact, between 1948 and 1958 there was no significant change in "share of the market."

Statistics applying to the new definition of a "chain," which constitutes 11 or more stores, indicate the following:

Percent of total sales

	1948	1958	1961
Independents—10 or less stores	60.0	58.2	57.3
Chains—11 or more stores	40.0	41.8	42.7

The very slight reduction in the independents' share of the market, in 1961, could well be the result of many independents, assisted and encouraged by multiple surtax exemptions, expanding into chains of 10 or more.

There is no indication in these figures that shoe chains, which have multiple surtax exemptions, are significantly affecting independents' share of the market. To the best of my knowledge, no evidence has been presented to establish that multiple surtax exemptions have been prejudicial to small business. Nevertheless, the proposed penalty has been predicated on this unsupported premise.

It is of particular importance to note, that retail stores are receiving little assistance in their program of expansion from the investment credit enacted in 1962. The major portion of the capital expenditures involved in the installation of new stores, and the rehabilitation of old ones, consist of improvements to real estate and other installations such as central air conditioning, attractive facades, electrical service excluding electrical fixtures, and wiring, all of which are ineligible for application of the credit.

There may be an attitude that corporations entitled to multiple surtax exemptions, despite a proposed penalty of 6 percent, resulting in a rate of 28 versus 30 percent, are at no disadvantage compared to the present rate. Legislation based on this conclusion would be a regrettable mistake.

Small- and medium-sized specialty stores, in the same line of business, are in competition with each other. They should enjoy the same tax rates, whether individually owned, or component members of a chain. Neither should be handicapped by a penalty on tax rates that affects both the consumer and the stockholders, and further expansion.

Presently, all stores with taxable income up to $25,000 have the same tax rate, except for the additional tax on intercorporate dividends paid by corporations in a related group. Under the provisions of the House bill, stores operated in related corporations will be at an even greater competitive disadvantage. That is wrong—as a matter of equity and as a matter of good economics.

There should be a 100-percent exclusion for intercorporate dividends in cases of corporations under common control.

If, as proposed in H.R. 8363, the 2-percent additional tax is repealed for corporations filing consolidated returns, this will automatically result in the elimination of the intercorporate dividend tax in such cases.

In that event, many more corporations operating subsidiaries, henceforth relieved of the 2-percent additional tax or penalty, will elect to file consolidated returns, enjoy 100-percent exclusion of intercorporate dividends, and offset losses against profits for the purpose of reducing their tax liability. We are in favor of this proposed legislation.

The intercorporate dividend tax which, in effect, creates a triple tax on profits, is a "bridge toll" on profits enroute to stockholders. If the provisions of a tax bill are intended to make more money available for consumer expenditures to stimulate our economy, then the unjustifiable whittling away of profits, available for dividends to stockholders, should be terminated.

Presently, corporations operating through related groups which, according to Treasury's exhibits, average a taxable profit of approximately $11,000—less than one-half the amount of the allowable surtax exemption—should not be saddled with an intercorporate dividend tax of over 5 percent, calculated on subsidiary income, before this income is made available for dividends to stockholders, or for the purpose of expansion.

As a result of the proposed elimination of the 2-percent additional tax, or penalty, on consolidated returns, the loss of revenue, in the further elimination of the intercorporate dividend tax in the case of related corporations entitled to multiple surtax exemptions, should be relatively insignificant and of little consequence to Treasury.

The amendment to section 1551, inserting the word "indirectly," should be eliminated, or clarified, so that it will not prohibit expansion.

The House bill also made a basic change in present section 1551, which will have an unintended effect, and result in a rash of unnecessary tax cases attributable to ambiguity.

Presently, section 1551, does not affect the transfer of money to a new corporation organized for the purpose of expansion.

The section reads as follows:

If any corporation transfers on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under sec. 269(b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) * * *

In addition, to avoid any misinterpretation in the application of section 1551, the Treasury Department itself issued final regulations, which appear as Treasury Decision 6024, in the Federal Register for July 1, 1953, which provided that—

* * * the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 15(c)—

later 1515—

irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

The House bill amendment provides that—

* * * if a corporation transfers property (other than money), directly or indirectly * * *.

to a corporation which it controls, the Secretary of the Treasury, or his delegate, may disallow the $25,000 exemption, and so forth.

It is my understanding, despite the example to the contrary in the report of the Ways and Means Committee and my opinion has been confirmed since that time, I believe, that the addition of the word "indirectly," was not intended to preclude the formation of new corporations for the purpose of expansion, but rather to prohibit the formation of a new corporation, that would subsequently acquire an existing business or assets from the parent, which did not result in expansion, and that is wrong.

Section 1551 without amendment, presently, has adequate provision to prevent such violations.

Most chainstore organizations operate central warehousing facilities. When, in expansion, a new store is scheduled to be opened, merchandise, fixtures, and supplies are ordered for the store, held in the warehouse, and then reshipped to the new store when construction is completed and the premises are ready to receive shipments. The subsidiary operating the store subsequently pays for merchandise and other items from available funds, in the normal course of business.

These transactions might be misinterpreted as a transfer of money, "indirectly," to acquire assets from the parent.

If such an interpretation is applied to the wording of section 1551, as modified in H.R. 8363, it would be impossible to form new corporations for the purpose of expansion, unless such corporations forfeit their right to the surtax exemption, or unless such organizations are materially handicapped by being forced to abandon—to change their operation and abandon central warehousing.

Central warehousing is a predominant method of operation in organizations conducting chains of stores. I do not believe the technical staff responsible for drafting this provision was aware of the impact of central warehousing operations. If it were, then the amendment was designed to completely nullify section 1551 in its effect on future expansion.

The intent of section 1551, as amended in H.R. 8363, should be clarified by eliminating the word "indirectly," so this section cannot be construed to deny new corporations, formed for purpose of expansion, their intended surtax exemption.

Repeating our objectives, I am respectfully requesting this committee consider:

1. The elimination of the 6-percent penalty.
2. A 100-percent exclusion of intercorporate dividends received in the case of corporations under common control.
3. The elimination of the word, "indirectly," introduced as an amendment to section 1551, or a specific clarification in the text that will not prohibit expansion.

Section 1551, as it presently appears in the 1954 code, has effectively, and consistently, accomplished its objective by preventing splitups, encouraging expansion, and promoting productivity and employment. It has accomplished this without having been prejudicial to any segment of business—large, medium, or small.

We believe it to be in the best interest of our national economy for this section to remain unchanged.

I will be very happy to answer any questions, or expand on any phase of this testimony, if it will be of assistance to the committee in reaching a decision.

I also wish to express my appreciation to the chairman and other members of the committee, on behalf of the association and myself, for the privilege and the opportunity of testifying on this important matter, and the three objectives that are of vital importance to those related corporations that have enjoyed multiple surtax exemptions in the past.

Thank you very much, sir.

The CHAIRMAN. Thank you, Mr. Herrmann. Any questions?

Senator GORE. Thank you, I found your statement very interesting.
Mr. HERRMANN. Thank you, sir.
Senator WILLIAMS. Mr. Herrmann, you have made some suggestions which should and will be considered by the committee, but I have one question.
Just in the event that none of those suggestions are accepted and the bill is left in the form in which it passed the House are you for or against the bill?
Mr. HERRMANN. I think, Senator Williams, that it would be a matter of self-interest and certainly contrary to the welfare of this country for us to predicate any attitude about House bill 8363 on the premise that would be, reform would be, either to our advantage or disadvantage.
Frankly, if this committee was in favor of other provisions of this bill and if this committee were not in favor of doing any of the things that we have requested before your committee today, we would not predicate our favor or disfavor of the bill on multiple surtax exemptions. I think that consideration of this bill is far too important to have it revolve around multiple surtax exemptions and very, very frankly if we were denied any of the relief that we asked for and if you and other members of the committee were of the opinion that other sections of this bill should be enacted for the good and welfare of the Nation, we would be all for it, sir.
Senator WILLIAMS. Thank you, no further questions.
The CHAIRMAN. Thank you very much.
The next witness is Virginia R. Allan of the National Federation of Business and Professional Women's Clubs.
Would you please come forward and take a seat? We are very glad to have you before the committee.

STATEMENT OF VIRGINIA R. ALLAN, PRESIDENT, NATIONAL FEDERATION OF BUSINESS AND PROFESSIONAL WOMEN'S CLUBS, INC.

Miss ALLAN. Thank you, Senator Byrd.
Mr. Chairman and members of the committee, I am Virginia R. Allan, president of the National Federation of Business and Professional Women's Clubs, Inc., the largest organization in the world dedicated to the interests of women in business and in the professions.
I have here with me today Isabelle M. Allias on my left, the national legislation chairman, and Mrs. Hattie Trazenfeld, our legislation director. They are with me and willing to testify.
I wish to thank you and the members of your committee most sincerely for this opportunity to present the views of our federation members, many of them working mothers, and to assure you of their support of the amendments to H.R. 8363 which Senator Neuberger has introduced.
The federation finds that the tax deduction allowance now provided under the law falls far short of achieving its objective—to give real tax relief to those who need it most.
Nor does H.R. 8363, as passed by the House, meet the needs of most working married couples. The $4,500 income limitation for married couples, adopted in 1954 is retained, as is the $600 limitation on deduc-

tions. This, in spite of the fact that incomes and the cost of living have advanced considerably since 1954.

In that year, the median income of families where both husband and wife were in the labor force was approximately $5,336; by 1961 it had risen to $7,188. Surely it is obvious, in the light of these data, that the present House bill is highly unrealistic. The joint husband-wife limitation is so low as to exclude most married couples from the benefits of the bill.

The current tax law recognizes the need for tax deductions for many espenses essential to employment. Certainly the cost of child care while a mother works is such an expense and the relief provided should be adequate to meet the need.

We were pleased to note that the House increased the allowable deduction to $900 for two or more dependents for widows, widowers, and single women but we protest the exclusion of married women from this provision. There seems to be little logic in increasing benefits for some categories but not for all.

The amendments suggested by Senator Neuberger would correct the inequities and bring the bill more nearly into line with today's needs. For this reason the federation gives it our wholehearted support.

Child care is hardly a luxury item. Nearly 3 million mothers of children under 6 are employed, even though there is a husband in the family. Most of them work because they must—to make ends meet. In order to do their jobs efficiently these mothers need the assurance that their children are properly cared for during working hours.

The Nation, too, needs the assurance that children of working mothers are not left to shift for themselves or roam the streets while their parents work. We can have such assurance if we are willing to open the way for their care by providing tax relief to their parents. To the business and professional women in our organization this seems like good business—an investment in the future.

The CHAIRMAN. Thank you very much, Miss Allan. Any questions? Thank you, and we will certainly give the fullest consideration.

Miss ALLAN. Thank you very much for hearing our testimony.

The CHAIRMAN. Now, the next witness is Mrs. Julia C. Thompson of the American Nurses' Association.

Senator CARLSON. Mr. Chairman, I want the members of the committee to know that this fine lady is a Kansas girl who has made an outstanding record in the field of nursing.

Mrs. THOMPSON. Thank you.

The CHAIRMAN. Thank you. We are glad to have you, Mrs. Thompson.

STATEMENT OF JULIA C. THOMPSON, R.N., AMERICAN NURSES' ASSOCIATION

Mrs. THOMPSON. I am Julia C. Thompson, Mr. Chairman. I am the Washington representative for the American Nurses' Association. The American Nurses' Association is the national association of professional nurses with approximately 169,000 constituents.

I have a prepared statement which I will summarize and request that the entire statement be inserted in the record.

The CHAIRMAN. Without objection, it will be inserted in the record.

Mrs. THOMPSON. Nurses are not only wage earners and taxpayers but they are for the most part women. In common with many of the 24 million women in the labor force, they are often wives and mothers. Often also, in order to work, they must make arrangements for the care of young children during those hours when they are absent from the home. The cost of such arrangements is an allowable tax deduction under certain conditions. The American Nurses' Association is convinced that those conditions are in need of substantial revision.

Two proposals for revision of the child care and disabled dependents deductions are now before this committee. The one is embodied in the text of the House-passed bill, H.R. 8363.

The second is found in amendment 209 introduced by Senator Maurine Neuberger. We have examined the dependents deduction provisions of H.R. 8363 and amendment 209 against our criteria for meaningful tax relief.

The age limit of qualifying children should be raised. At present, parents may deduct child care expenses only for children 11 years of age or younger. Under H.R. 8363, the age limit of children who qualify is raised from 11 to 12 years and this has our full support.

The eligible categories of taxpayers should be expanded. Under the provisions of the present law, working women, widowers, and divorced men may be eligible for the deduction. The working wife of a mentally or physically incapacitated husband is eligible for the maximum child care allowance. The husband whose wife is incapacitated is not eligible for any child care deduction, although the need for child care in such a family is clearly demonstrable.

In part this inequity in treatment is corrected by H.R. 8363 which extends eligibility for the deduction to the married man whose wife is confined to an institution. We urge the adoption of this provision and further recommend that eligibility be extended to the husbands of all incapacitated wives, whether the wife is institutionalized or not. The Bureau of Internal Revenue has had some 9 years of experience in the application of this provision to the wives of disabled husbands and surely this experience should provide a sound basis on which to develop the necessary regulations for the husbands of disabled wives.

The proposed maximum allowable deductions are inadequate. Under H.R. 8363, the maximum allowable deduction for one dependent remains at exactly the level established in 1954—$600.

For two or more dependents, however, the maximum allowable deduction is increased to $900.

However, families in which both husband and wife work are discriminated against under H.R. 8363. For these families, the maximum allowable deduction and the joint income limitation remain identical with that established under the Internal Revenue Act of 1954. Their maximum allowable deduction is $600, irrespective of the number of children.

Moreover, the full $600 deduction is available only to couples whose joint income does not exceed $5,100 a year. For every dollar of joint income over $4,500, a dollar is subtracted from the $600 allowance. Since 1954, we would point out that median income of families in which both husband and wife work rose from $5,336 to $7,461 in 1962.[1]

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[1] U.S. Bureau of the Census, "Current Population Reports, Series P-60, Nos. 20 and 4.

Under amendment No. 209, the married working woman fares somewhat better. The family is eligible for the full deduction which can be as high as $1,000 where there are three children. The joint income limitation is raised from $4,500 to $7,000.

In the opinion of the American Nurses' Association, the maximum allowable deductions established under H.R. 8363 and amendment No. 209 are arbitrary and have little relation to the actual costs of care for children or disabled dependents. At the income level at which parents can afford more than $1,000 for child care, the effects are particularly discriminatory.

In 1953, the testimony before the House Committee on Ways and Means, the ANA spokesman urged that deduction of child care expenses be allowed up to 75 percent of the income produced—in the case of the working wife, up to 75 percent of her income.

In terms of the kind of tax relief that will make it feasible for a wife and mother to resume work, that proposal is still both reasonable and realistic. In terms of the costs that can be incurred in providing for child care or in the care of disabled dependents, we feel that proposal is still sound.

The proposed deduction limitations discourage mothers from working. From the viewpoint of the national economy and the public interest, there is a great deal to be gained from encouraging women and mothers to work. They are badly needed in a variety of shortage occupations—as teachers, social workers, typists, secretaries.

As the representative of the nursing profession, we would direct the committee's particular attention to the country's critical need for more nurses in active employment. Appropriate tax relief can have only a salutary effect on bringing inactive nurses back into a profession in which there is a serious shortage.

There are jobs today for nurses in all fields. Twenty percent of the budgeted nursing positions in non-Federal general hospitals are vacant.[2]

Last January, there were 1,157 budgeted teaching vacancies in college and hospital schools of nursing—compared to 996 in 1960.[3]

By 1970, another 300,000 nurses will be needed in the country as a whole.[4]

Where will they come from? Of the estimated 550,000 professional nurses in active practice, at least 117,000 hold part-time positions.[5]

Many work during hours when the husband or relative can care for children. With realistic tax relief for the expense of babysitting help, some would be able to accept full-time employment.

Of the nearly half million nurses not active, 200,000 still maintain their license to practice and probably expect to become active again someday.[6]

Of these 200,000, 85 percent are married, many with small children. Yet, married nurses are reluctant to return to work. University

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[2] American Nurses' Association, "Spot Check of Current Hospital Nursing Employment Conditions, November 1962."

[3] American Nurses' Association, "Facts About Nursing," 1962–63 ed., p. 52.

[4] U.S. Department of Health, Education, and Welfare, Public Health Service. "Toward Quality in Nursing." Report of the Surgeon General's Consultant Group on Nursing, February 1963, p. 23.

[5] "Facts About Nursing," p. 7.

[6] U.S. Department of Health, Education, and Welfare, Public Health Service. "Toward Quality in Nursing." Report of the Surgeon General's Consultant Group on Nursing, February 1963, p. 20.

schools of nursing, which offer some of the highest salaries in nursing, report that an increasing number of married women do not accept faculty positions because, even for these positions, salaries are not sufficiently high to cover the cost of child care and still leave enough to make full-time employment attractive.

A general duty nurse, working full time, averages $4,080 a year.[7] We assume her husband is a better-than-average wage earner—perhaps a professional man himself, or a technical worker or skilled craftsman—earning approximately $8,000 a year.

How does the present child care deduction, or that proposed under either H.R. 8363 or amendment No. 209 affect the decision of the nurse now home taking care of her children to resume her career?

On her husband's earnings—assuming a joint return, the standard deduction, and four exemptions—for husband, wife, and two children—the family's income after taxes is $7,024.

Attached to this statement is a table which shows the numerical calculation we have done which shows that it is not economical for her to return to work.

If she returns to work, she can deduct no part of any child care expenses incurred because their joint income is $12,080—above the level contemplated in H.R. 8363 and amendment No. 209. The family income after taxes would be $10,233.

If this family has employed a full-time caretaker at $3,000 a year, the family income after taxes and after child care expense is $7,233—or just $199 more than if the nurse had not worked at all.

For 2,000 hours of nursing, this family nets $199. I think it is clear that in these circumstances the nurse does not return to work and the Government coffers are poorer by the tax she does not pay.

Under the ANA proposal, the working mother would be able to deduct up to 75 percent of her earnings. In the case of our nurse, the allowable deduction would be $3,060. However, we assume that she is able to document expenses only up to $3,000. The tax on the joint income would be $1,170—$194 more to the Government than if she had not worked.

The family income after taxes and after meeting the expenses of child care is $7,910. The family in this instance nets $886 more than if the wife does not work. From this $886, the working nurse has had extra expenses—for carfare, lunches, uniforms, and the other expenses incidental to holding a job.

Obviously, when a full-time child caretaker is required, it is only in the family most hard pressed for extra income that the mother will return to work. When the wife works, the only way to maximize family income after taxes and child care costs, is to reduce the costs of child care.

Perhaps the children are old enough to require only half-time baby-sitting, at half the cost. Working full time, with child care expenses of $1,500 fully deductible, the family's income after taxes and after child care expenses will be $9,080—$2,056 more than if she does not work.

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[7] American Nurses' Association, "Spotcheck of Current Hospital Nursing Employment Conditions," November 1962.

The tax on their joint income would be $1,500—$524 more to the government than if she had not worked. The caretaker will have had part-time employment that she otherwise would not have had. Society will have had 2,000 hours more of nursing care. The family is able to buy that much more of the goods and services produced by our economy.

The proposed allowances do not reflect costs of care. In 1958, the U.S. Department of Health, Education, and Welfare surveyed the child care arrangements of full-time working mothers.[8]

At that time, approximately 2.9 million women with at least one child under 12 years old were employed on a full-time basis.

Some 21 percent of the children were looked after by someone outside the family, either in their own home or in the home of the caretaker. It can safely be assumed that in most instances this unrelated someone was an employee, hired by the mother at the going rate for such work. The full-time working mother of a very young or a disabled child must have full-time help. At today's salaries, a year of child care—2,000 hours of child care—cannot be purchased for much under $3,000.

Just 2 percent of the children were covered in such group facilities as nurseries, day-care centers, settlement houses, and nursery schools. The costs of these arrangements vary widely, but modest fees scaled to parents' ability to pay are not uncommon.

Group facilities can and often do offer child care at considerable less cost than that involved in employing full-time help in the home. But across the country, licensed day care is available to some 185,000 children only.[9]

When you consider that 3 million mothers of children under 6 are in the labor force,[10] the gross inadequacy of present day care facilities is readily apparent. Given the cost of full-time care at home and the inadequacy of day-care centers, it is not surprising that the HEW study found that four out of five children were looked after under arrangements involving little or no expense—and sometimes little or no care as well.

While 16 percent were looked after by their father, 41 percent were left in the care of other relatives, including older brothers and sisters; 8 percent, primarily of school age, were caring for themselves. Obviously, without what must often be makeshift arrangements and the free services of other members of the family, many mothers would not be able to work.

More costly than the care of well children, is the cost of care for the disabled, the incapacitated, the physically or mentally handicapped child or adult. A large proportion of income can be expended in providing the necessary care, over and above medical care, required by these people. The responsible person often finds himself faced with extraordinary expenses.

The child care and disabled dependent deduction is intended to defray two types of costs: that of hiring someone to care for the child or disabled dependent, and that of placing him in such care centers as a day school, boarding school, or nursing home.

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[8] U.S. Department of Labor, Women's Bureau, 1962 Handbook on Women Workers, p. 54.
[9] Report of the President's Commission on the State of Women, "American Women," 1963, p. 19.
[10] Ibid.

Neither at the present level, nor at the levels contemplated under H.R. 8363 and amendment No. 209 are the amounts allowable for child care and disabled dependent deduction adequate. Hiring a full-time caretaker for child or adult is virtually impossible today at less than $3,000 a year.

Even the cost of institutional care for a mentally or physically incapacitated child or adult runs upward of $2,500 a year. The allowable amounts contemplated could conceivably cover the fees of most day care centers or nursery schools—but these facilities are available to a ridiculously small proportion of working mothers.

Moreover, the costs for the care of children and disabled dependents will rise in the coming years just as they have risen in the years since the dependents' deduction was introduced.

Although $600 buys much less child care today than it did in 1954—it will buy even less in the years ahead. Tax legislation is not revised every year. The allowances set this year may well be effective for some years to come. We oppose the setting of fixed dollar maximums on the allowable deduction for just this reason—they become outdated very rapidly.

We believe the allowable deduction for child care should be related to what the parents can afford and what they can obtain, not to an arbitrary standard that becomes outdated.

Three-fifths of the mothers who are widowed, divorced, or separated are in the labor force.[11]

By and large they must work to support themselves and their children. Our tax laws should encourage them to purchase the level of child care that they can afford and not penalize them when they exceed some arbitrary limit.

If $200 or $600 will buy the required care, then that is all that can be deducted. But if it takes $3,000, and the mother can afford $3,000, then she should be able to deduct $3,000.

Strict enforcement of the current regulations respecting the circumstances under which a deduction can be claimed should be sufficient to prevent tax abuse. That is, the expense claimed must be substantiated; if the caretaker divides her time between household chores and child care, then her salary must be allocated between the time spent in caring for the child and the time spent in household duties; the expenses must have been incurred while the taxpayer was gainfully employed or actively seeking gainful employment.

Because the present allowance is inadequate, many mothers who must work are forced to resort to makeshift arrangements for the care of their children and our children are the losers. Mothers who would return to work, were they allowed a deduction more closely corresponding to the costs of child care, are deterred from doing so—and our country is the loser.

We hope very much that this committee will give favorable consideration to these proposals of the American Nurses' Association.

Mr. Chairman, I have with me a joint statement which has been signed by five organizations including the American Nurses' Association, which supports the revisions in H.R. 8363 and amendment No. 209 and I would request that this be included in the record at this time.

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[11] U.S. Department of Labor, Women's Bureau, 1962 Handbook on Women Workers, p. 51.

The CHAIRMAN. Without objection it will be put in the record. Thank you very much Mrs. Thompson.

(The statement referred to follows:)

STATEMENT OF JULIA C. THOMPSON, R.N., WASHINGTON REPRESENTATIVE, AMERICAN NURSES' ASSOCIATION

I am Julia C. Thompson. I appear before this committee on behalf of the American Nurses' Association. The American Nurses' Association is the national professional organization of registered nurses. Its membership of more than 169,000 is distributed across 50 States, the District of Columbia, Puerto Rico, the Virgin Islands, and the Panama Canal Zone.

Nurses are not only wage earners and taxpayers but are from the most part women. In common with many of the 24 million women in the labor force, they are often wives and mothers. Often also, in order to work, they must make arrangements for the care of young children during those hours when they are absent from the home. The cost of such arangements is an allowable tax deduction under certain conditions. The American Nurses' Association is convinced that those conditions are in need of substantial revision.

Two proposals for revision of the child care and disabled dependents deduction are now before this committee. The one is embodied in the text of the House-passed bill, H.R. 8363. The second is found in amendment 209 introduced by Senator Maurine Neuberger. We have examined the dependents deduction provisions of H.R. 8363 and amendment No. 209 against our criteria for meaningful tax relief.

THE AGE LIMIT OF QUALIFYING CHILDREN SHOULD BE RAISED

At present, parents may deduct child care expenses only for children 11 years of age or younger. Under H.R. 8363, the age limit of children who qualify is raised from 11 to 12 years and this has our full support.

THE ELIGIBLE CATEGORIES OF TAXPAYERS SHOULD BE EXPANDED

Under the provisions of the present law, workingwomen, widowers and divorced men may be eligible for the deduction. The working wife of a mentally or physically incapacitated husband is eligible for the maximum child care allowance. The husband whose wife is incapacitated is not eligible for any child care deduction, although the need for child care in such a family is clearly demonstrable. In part this inequity in treatment is corrected by H.R. 8363 which extends eligibility for the deduction to the married man whose wife is confined to an instituiton. We urge the adoption of this provision and further recommend that eligibility be extended to the husbands of all incapacitated wives, whether the wife is institutionalized or not. The Bureau of Internal Revenue has had some 9 years of experience in the application of this provision to the wives of disabled husbands and surely this experience should provide a sound basis on which to develop the necessary regulations for the husbands of disabled wives.

THE PROPOSED MAXIMUM ALLOWABLE DEDUCTIONS ARE INADEQUATE

Under H.R. 8363, the maximum allowable deduction for one dependent remains at exactly the level established in 1954—$600. For two or more dependents, however, the maximum allowable deduction is increased to $900.

However, families in which both husband and wife work are discriminated against under H.R. 8363. For these families, the maximum allowable deduction and the joint income limitation remain identical with that established under the Internal Revenue Act of 1954. Their maximum allowable deduction is $600, irrespective of the number of children. Moreover, the full $600 deduction is available only to couples whose joint income does not exceed $5,100 a year. For every dollar of joint income over $4,500, a dollar is subtracted from the $600 allowance. Since 1954, we would point out that median income of families in which both husband and wife work rose from $5,336 to $7,461 in 1962.[1]

[1] U.S. Bureau of the Census, "Current Population Reports," Series P-60, No. 20 and No. 4.

Under amendment No. 209, the married workingwoman fares somewhat better. The family is eligible for the full deduction which can be as high as $1,000 where there are three children. The joint income limitation is raised from $4,500 to $7,000.

In the opinion of the American Nurses' Association, the maximum allowable deductions established under H.R. 8363 and amendment No. 209 are arbitrary and have little relation to the actual costs of care for children or disabled dependents. At the income level at which parents can afford more than $1,000 for child care, the effects are particularly discriminatory. In 1953, in testimony before the House Committee on Ways and Means, the ANA spokesman urged that deduction of child care expenses be allowed up to 75 percent of the income produced—in the case of the working wife, up to 75 percent of her income. In terms of the kind of tax relief that will make it feasible for a wife and mother to resume work, that proposal is still both reasonable and realistic. In terms of the costs that can be incurred in providing for child care or in the care of disabled dependents, we feel that proposal is still sound.

THE PROPOSED DEDUCTION LIMITATIONS DISCOURAGE MOTHERS FROM WORKING

From the viewpoint of the national economy and the public interest, there is a great deal to be gained from encouraging women and mothers to work. They are badly needed in a variety of shortage occupations—as teachers, social workers, typists, secretaries.

As representative of the nursing profession, we would direct the committee's particular attention to the country's critical need for more nurses in active employment. Appropriate tax relief can have only a salutary effect on bringing inactive nurses back into a profession in which there is a serious shortage.

There are jobs today for nurses in all fields. Twenty percent of the budgeted nursing positions in non-Federal general hospitals are vacant.[2] Last January there were 1,157 budgeted teaching vacancies in college and hospital schools of nursing—compared to 996 in 1960.[3] By 1970, another 300,000 nurses will be needed in the country as a whole.[4]

Where will they come from? Of the estimated 550,000 professional nurses in active practice, at least 117,000 hold part-time postions.[5] Many work during hours when the husband or relative can care for children. With realistic tax relief for the expense of babysitting help, some would be able to accept full-time employment.

Of the nearly half million nurses not active, 200,000 still maintain their license to practice and probably expect to become active again some day.[6] Of these 200,000, 85 percent are married, many with small children. Yet, married nurses are reluctant to return to work. University schools of nursing, which offer some of the highest salaries in nursing, report that an increasing number of married women do not accept faculty positions because, even for these positions, salaries are not sufficiently high to cover the cost of child care and still leave enough to make full-time employment attractive.

A general duty nurse, working full time, averages $4,080 a year.[7] We assume her husband is a better than average wage earner—perhaps a professional man himself, or a technical worker or skilled craftsman—earning $8,000 a year.

How does the present child care deduction, or that proposed under either H.R. 8363 or amendment No. 209 affect the decision of the nurse now home taking care of her children to resume her career?

On her husband's earnings—assuming a joint return, the standard deduction, and four exemptions—for husband, wife, and two children—the family's income after taxes is $7,024. (This calculation as well as those for other examples I will give are shown in detail in the attached table, p. 2492.)

[2] American Nurses' Association, "Spotcheck of Current Hospital Nursing Employment Conditions, November 1962."
[3] American Nurses' Association, "Facts About Nursing," 1962–63 ed., p. 52.
[4] U.S. Department of Health, Education, and Welfare, Public Health Service. "Toward Quality in Nursing." Report of the Surgeon General's Consultant Group on Nursing, February 1963, p. 23.
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If she returns to work, she can deduct no part of any child care expenses incurred because their joint income is $12,080—above the level contemplated in H.R. 8363 and amendment No. 209. The family income after taxes would be $10,233. If this family has employed a full-time caretaker at $3,000 a year, the family income after taxes and after child care expense is $7,233—or just $199 more than if the nurse had not worked at all. For 2,000 hours of nursing, this family nets $199. I think it is clear that in these circumstances the nurse does not return to work and the Government coffers are poorer by the tax she does not pay.

Under the ANA proposal, the working mother would be able to deduct up to 75 percent of her earnings. In the case of our nurse, the allowable deduction would be $3,060. However, we assume that she is able to document expenses only up to $3,000. The tax on the joint income would be $1,170—$194 more to the Government than if she had not worked. The family income after taxes and after meeting the expenses of child care is $7,910. The family in this instance nets $886 more than if the wife does not work. From this $886, the working nurse has had extra expenses—for carfare, lunches, uniforms, and the other expenses incidental to holding a job.

Obviously, when a full-time child caretaker is required, it is only in the family most hard pressed for extra income that the mother will return to work. When the wife works, the only way to maximize family income after taxes and child care costs, is to reduce the costs of child care. Perhaps the children are old enough to require only half-time babysitting, at half the cost. Working full-time, with child care expenses of $1,500 fully deductible, the family's income after taxes and after child care expenses will be $9,080—$2,056 more than if she does not work. The tax on their joint income would be $1,500—$524 more to the Government than if she had not worked. The caretaker will have had part-time employment that she otherwise would not have had. Society will have had 2,000 hours more of nursing care. The family is able to buy that much more of the goods and services produced by our economy.

THE PROPOSED ALLOWANCES DO NOT REFLECT COSTS OF CARE

In 1958, the U.S. Department of Health, Education, and Welfare surveyed the child care arrangements of full-time working mothers.[8] At that time, approximately 2.9 million women with at least 1 child under 12 years of age were employed on a full-time basis.

Some 21 percent of the children were looked after by someone outside the family, either in their own home or in the home of the caretaker. It can safely be assumed that in most instances this unrelated "someone" was an employee, hired by the mother at the going rate for such work. The full-time working mother of a very young or a disabled child must have full-time help. At today's salaries, a year of child care—2,000 hours of child care—cannot be purchased for much under $3,000.

Just 2 percent of the children were covered in such group facilities as nurseries, day-care centers, settlement houses, and nursery schools. The costs of these arrangements vary widely, but modest fees or fees scaled to parents' ability to pay are not uncommon.

Group facilities can and often do offer child care at considerable less cost than that involved in employing full-time help in the home. But across the country, licensed day care is available to some 185,000 children only.[9] When you consider that 3 million mothers of children under 6 are in the labor force,[10] the gross inadequacy of present day-care facilities is readily apparent. Given the cost of full-time care at home and the inadequacy of day-care centers, it

[8] U.S. Department of Labor, Women's Bureau, 1962 Handbook on Women Workers, p. 54.
[9] Report of the President's Commission on the Status of Women, "American Women," 1963, p. 19.
[10] Ibid.

is not surprising that the HEW study found that four out of five children were looked after under arrangements involving little or no expense—and sometimes little or no care as well. While 16 percent were looked after by their father, 41 percent were left in the care of other relatives, including older brothers and sisters; 8 percent, primarily of school age, were caring for themselves. Obviously, without what must often be makeshift arrangements and the free services of other members of the family, many mothers would not be able to work.

More costly than the care of well children, is the cost of care for the disabled, the incapacitated, the physically or mentally handicapped child or adult. A large proportion of income can be expended in providing the necessary care, over and above medical care, required by these people. The responsible person often finds himself faced with extraordinary expenses.

The child care and disabled dependent deduction is intended to defray two types of costs: that of hiring someone to care for the child or disabled dependent, and that of placing him in such care centers as a day school, boarding school or nursing home.

Neither at the present level, nor at the levels contemplated under H.R. 8363 and amendment No. 209 are the amounts allowable for child care and disabled dependent deduction adequate. Hiring a full-time caretaker for child or adult is virtually impossible today at less than $3,000 a year. Even the cost of institutional care for a mentally or physically incapacitated child or adult runs upward of $2,500 a year. The allowable amounts contemplated could conceivably cover the fees of most day-care centers or nursery schools—but these facilities are available to a ridiculously small proportion of working mothers.

Moreover, the costs for the care of children and disabled dependents will rise in the coming years just as they have risen in the years since the dependents' deduction was introduced. Six hundred dollars buys much less child care today than it did in 1954—and will buy even less in the years ahead. Tax legislation is not revised every year. The allowances set this year may well be effective for some years to come. We oppose the setting of fixed dollar maximums on the allowable deductions for just this reason—they become outdated.

We believe the allowable deduction for child care should be related to what the parents can afford and what they can obtain, not to an arbitrary standard that becomes outdated. Three-fifths of the mothers who are widowed, divorced, or separated are in the labor force.[11] By and large they must work to support themselves and their children. Our tax laws should encourage them to purchase the level of child care that they can afford and not penalize them when they exceed some arbitrary limit.

If $200 or $600 will buy the required care, then that is all that can be deducted. But if it takes $3,000, and the mother can afford $3,000, then she should be able to deduct $3,000. Strict enforcement of the current regulations respecting the circumstances under which a deduction can be claimed should be sufficient to prevent tax abuse. That is, the expense claimed must be substantiated; if the caretaker divides her time between household chores and child care, then her salary must be allocated between the time spent in caring for the child and the time spent in household duties; the expenses must have been incurred while the taxpayer was gainfully employed or actively seeking gainful employment.

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We hope very much that this committee will give favorable consideration to these proposals of the American Nurses' Association.

[11] U.S. Department of Labor, Women's Bureau, 1962 Handbook on Women Workers, p. 51.

Effect of child care deduction on family income under present law and under ANA proposal[1]

	Under present law		Under ANA proposal	
	No child care expense	Full-time child care expense	Full-time child care expense	Part-time child care expense
Total assumed family income	$8,000	$12,080	$12,080	$12,080
Husband's income	8,000	8,000	8,000	8,000
Wife's income	None	4,080	4,080	4,080
Calculation of income tax:				
Standard deduction (10 percent or $1,000)	800	1,000	1,000	1,000
Exemptions assumed (4 at $600)	2,400	2,400	2,400	2,400
Child care deduction:				
Amount allowable	None	None	3,060	3,060
Assumed actual expense	None	3,000	3,000	1,500
Amount claimed	None	None	3,000	1,500
Total deductions	3,200	3,400	6,400	4,900
Income base for figuring tax	4,800	8,680	5,680	7,180
Total income tax	976	1,857	1,170	1,500
Family income after income tax	7,024	10,223	10,910	10,580
Assumed actual child care expense	None	3,000	3,000	1,500
Net family income (after income tax and child care expense)	7,024	7,223	7,910	9,080

[1] Under present law, the family with an income in excess of $5,100 is not eligible for the child care deduction. Under the ANA proposal, the allowable child care deduction would be up to 75 percent of the wife's earnings.

Senator CARLSON. Mrs. Thompson, we appreciate very much your appearance here and the statement which you made in regard to the program of the American Nursing Association but better yet your brevity in presenting it.

Mrs. THOMPSON. Thank you very much. It is a pleasure to be here before the committee.

The CHAIRMAN. Thank you very much, indeed.

Now, the next witness is Mr. Peter Retzlaff of the National Football League Players Association.

Will you come forward, please, sir?

STATEMENT OF PETER RETZLAFF, PRESIDENT, NATIONAL FOOTBALL LEAGUE PLAYERS ASSOCIATION; ACCOMPANIED BY PETER T. POSMANTUR, LEGISLATIVE COUNSEL

Mr. RETZLAFF. Mr. Chairman and members of the committee, my name is Pete Retzlaff; I am a player for the Philadelphia Eagles, National Football League, and also currently serving as the president of the National Football League Players Association.

On my right here is Mr. Peter T. Posmantur, our legislative counsel for the association.

First of all, I would like to thank the Senate Finance Committee for extending an invitation to the National Football League Players Association to testify on H.R. 8363 and specifically on S. 2057, a bill to amend the Internal Revenue Code of 1954 to allow a deduction to professional athletes for depletion of their physical strength, stamina, or skills.

S. 2057 was introduced in the U.S. Senate of the 88th Congress on August 15, 1963, by the Honorable Russell Long, Senator from Louisiana, and subsequently was introduced as amendment 332 to the omnibus tax bill, H.R. 8363, by Senator Long on November 27, 1963.

We, the National Football League Players Association are in favor of the enactment into law of S. 2057, as an amendment to H.R. 8363.

The bill sets up a formula whereby a professional athlete is allowed as a deduction for a taxable year an amount which bears the same ratio to the income derived by him during the taxable year as the number "1" bears to the number of years in the "career span" of the sport in which such athlete participates.

In other words, if the career span were about 5 years the amount of deduction would be approximately 20 percent. If the average career span of the athlete would be 20 years the deduction would be 5 percent. The term "career span" is defined to mean the average number of years in which individuals who participate as players or contestants in a particular sport have the physical strength, stamina, and skill required to perform services regularly as a professional athlete.

In this business it is no secret that our careers are very short lived.

The bill goes on to limit this allowance of deduction in the following manner:

If an athlete had been entitled to a deduction for a number of taxable years equal to his "career span" whatever same may be in a particular sport, he would no longer be entitled to any deduction for any additional year unless he elected not to claim the deduction allowed by the bill for a prior taxable year and paid back into the Treasury the additional tax, together with interest thereon, which would have been payable if no deduction had been allowable for that prior taxable year.

An example of how the bill works would be as follows:

A professional football player's "career span" would be approximately 4 or 5 years, while a professional baseball player's "career span" may be as much as 8 years, and other professional sports' "career spans" could be as much as 15 or 20 years; the exact amount of years to be determined for each "career span" would have to be discovered by means of hearings, and, of course, the calling of witnesses and experts in the various sports.

In the case of a 4-year "career span" the deduction of course would be 25 percent, while in the case of a 20-year "career span," the deduction would be only 5 percent. The percentages are computed by merely dividing the number of years of the "career span" into the figure "1," as set forth in S. 2057.

As an illustration of the "exceptions" to the bill, it would be necessary to cite a specific example: For this purpose let us use the case of a professional football player with a 4-year "career span."

If said football player had taken his deduction for 4 years, in the fifth year he would no longer be eligible for such deduction unless he elected to pay back into the Treasury the additional tax together with interest thereon, which would have been payable if no deduction had been allowable for a prior taxable year.

A player could continue to elect to accept the deduction for any taxable year after his career span deduction has elapsed if he con-

tinues each and every year to pay the additional tax, plus interest thereon, for a prior year where he had already taken the "depletion deduction."

The bill goes on to define "professional athlete" to mean, "an individual who receives compensation (whether in the form of salary, purses, share of gate proceeds, minimum fees, or otherwise) for performing services as a player or contestant in a sport," and further defines the term "sport" to mean "an athletic activity involving games or contests requiring a high degree of physical strength, stamina, or skill by the players or contestants therein."

S. 2057 further sets up special rules as to income to be included under the subsection entitled "Income Derived as Professional Athlete."

Such income included compensation whether in the form of salary, purses, share of gate proceeds, minimum fees, or otherwise received by players or contestants for services performed in a sport as well as income from testimonials, endorsements, public appearances, and other activities, attributable to public recognition of such individual as a professional athlete.

The bill specifically excludes any income derived by athletes from the conduct of a trade or business whether or not such trade or business is associated with such individual's activities as a professional athlete.

For example, in my own particular case my own job off season in television or radio announcing would not be tax free. The special rules subsection further defines the situation where a professional athlete participates in more than one sport during any taxable year. The section clearly provides that the bill shall apply separately with respect to income derived by such individual from each sport.

The National Football League Players Association strongly favors the enactment of S. 2057 as an amendment to H.R. 8363, because it has for a long period of time been seriously concerned with the problem of the professional athlete whose source of income is in his unusual stamina, exceptional coordination, and muscular strength—all of which are definitely assets of a limited duration.

Since the average playing life of a professional football player is from 4 to 5 years, he is earning the bulk of his income in this relatively short period of time, and consequently must suffer the hardship of heavy taxation during these high-income years, and then for the most part earn relatively little afterward when he leaves the sport.

It is further significant to point out that when a professional athlete terminates his playing career and enters the world of commerce, he must do so without the benefit of any prior experience in commerce because partly of the many years he participated as a professional athlete for personal income and for the enjoyment of the general public.

Therefore, many of these athletes find themselves at a later state of life competing in the world of commerce with men many years their junior, and often find themselves without funds to supplement their reduced income during their embryonic years in commerce.

Naturally, due to their advanced age, they have the additional expenses, in most cases, of a wife and family and other obligations which are normally incumbent upon a man who has been a public figure during his early years.

The philosophy of S. 2057 is similar to that of a depreciation deduction or a depletion allowance.

The athlete depletes his natural resources of physical ability and muscular strength while earning a high income on which he is heavily taxed. Then he is no longer able to participate in the sport and to earn as high an income.

The bill seeks to correct this unfair tax situation by granting the professional athlete an annual tax deduction based on the average number of years a player participates in a sport and therefore cutting his tax during his high income years.

Mr. Chairman, on behalf of the National Football League Players Association and on behalf of every individual player of the National Football League, I would like to thank the Senate Finance Committee for inviting us here today. We thank you.

Senator DOUGLAS (presiding). Mr. Retzlaff, I want to congratulate you on this statement.

What you are saying is that you think professional athletes should have depletion allowance as well as oil, gas, sulfur, coal, iron ore, clamshells, oystershells, sand and gravel; is that right?

Mr. RETZLAFF. Yes, sir. In effect, I think we would be classified as about the same thing.

Senator DOUGLAS. I have been expecting, as long as these depletion allowances on minerals are continued, that we must, in all logic, expect such claims as you are advancing to be put forward, and I think there is a good deal of justice in them, as long as we provide these other depletion allowances.

I notice also that you are much more modest than the oil and gas group because in oil and gas, they get a tax-free allowance of 27½ percent of gross income up to 50 percent of net income, world without end, amen, or as long as the oil and gas is flowing; isn't that true?

Mr. RETZLAFF. Yes, sir. I believe it is true.

Senator DOUGLAS. I was down in Beaumont, Tex., a few years ago. At that time the big well which I think blew in around 1901 or 1902 was still going, and the depletion allowance has been paid ever since it went in, from I think, 1914, 1915 on.

Now, even Satchel Paige was not in the big leagues for as long a time as Old Spindletc ; is that correct?

Mr. RETZLAFF. Well, you would take an old fellow like Satchel Paige who I am sure has contributed much to the enjoyment of the American public in the way of sports, of course, is a great source of entertainment for the American public, would certainly be the exception rather than the rule, and the same way with fellows like Chuck Bednarik who played for us for 14 years and Y. A. Tittle currently performing for the New York Giants, I think, currently in his 14th year, are the exceptions and there is a great turnover the first and second year which keeps the average down to about right now, in the National Football League, to somewhere between 4 and 5 years.

Senator DOUGLAS. Your proposal is a most modest one, as I understand it. You are proposing to restrict the total amount of the credits to approximately 1 year's income, isn't that true?

Mr. RETZLAFF. Yes, sir; over a period of ——

Senator DOUGLAS. Just a year's income?

Mr. RETZLAFF. One taxable free year, whether it be a 5 or 25 span, it would still amount to 1 tax-free year.

Senator DOUGLAS. Yes. You see there is no limitation on oil and gas on the number of years, and it can continue forever and it is not retricted to the original cost, which has already been recovered as a matter of fact from the fast writeoff of exploration drilling and developmental costs.

Have you prepared the language for this?

Mr. RETZLAFF. Well, basically——

Senator DOUGLAS. I wonder if your attorney would prepare the language. I would like to offer this if the depletion allowance for oil and gas is not reduced.

Mr. POSMANTUR. This bill has been introduced by Senator Long, introduced on August 15.

Senator DOUGLAS. By Senator Long?

Mr. POSMANTUR. That is right.

Senator DOUGLAS. I think this proposal finds great favor with me providing we don't reduce the allowance on oil and gas.

May I ask you this? I naturally understand you would wish to consider the professional athletes. I was never good enough to become a professional athlete myself but what about moving picture actors? They have a brief career, like the flowers, many of them. Like the flowers of the meadows, they bloom and then disappear from sight.

Now it is true that some such as Gable and others continue for a long period of time, but most of them disappear rather quickly. Shouldn't they have a depletion allowance for the wastage of their natural assets of attraction?

Senator CARLSON. Will the Senator yield?

Senator DOUGLAS. I am having such a good time. [Laughter.]

I don't want to yield immediately but I will yield at the end of this colloquy.

Senator CARLSON. Would the Senator yield now? I was wondering why not U.S.—include U.S. Senators. They sometimes bloom.

Senator DOUGLAS. This might be a good idea but we will be suspected of enacting class legislation and conflicts of interest. As a matter of fact, frequently the earning power of a U.S. Senator increases after he is defeated because then he can become a lobbyist. [Laughter.]

Mr. RETZLAFF. Senator Douglas, in answer to your question——

Senator DOUGLAS. Would you like to include actors in this?

Mr. RETZLAFF. I don't think I would have any objection should they be included in any such provision such as this. However, not being familiar with their plight or their position, I don't feel qualified to speak.

Senator DOUGLAS. I understand You have to address yourself to your immediate occupation. I am told that television, like Cronus, devours its children, too, and after a few years on television the public gets fed up with one, and one retires. Hasn't this been a depletion of social attractiveness, and, therefore, would not the television personalities be entitled to a depletion allowance?

Mr. RETZLAFF. Well, we really, at least, have one shot so to speak at something of this sort, to earn a livelihood as a result of our physical ability which is depleting and that is usually from age 21 to probably 28 when young men are very strong.

Senator DOUGLAS. I am very sympathetic with you as long as this depletion for oil, gas, sulfur, clam shells, and oyster shells remains in the law. But if you get this, won't we be compelled logically to extend it to actors, to television personalities, and to politicians?

Mr. POSMANTUR. Senator, if I could answer it in this way, the athlete and specifically the National Football League only has one time. I am an attorney and we deplete also. But the athletes only have a period of 4 to 5 and 6 years in the extraordinary cases and there are a few cases such as Satchel Paige and Y. A. Tittle which come once every 10 or 15 years. In the case of an actor which we certainly have no objection, we are not qualified to speak in that field. They can change, reorient their style, and make a comeback. A football player can't do such a thing. Y. A. Tittle broke the record last week by throwing 197 touchdown passes. It isn't going to do him any good incomewise or he is not going to be able to make a comeback 3 years from now because his coordination is not going to be there any more, whether it is 3 or 4 or how many years are left. That is the way we feel and we distinguish our situation.

Pete last night mentioned there are only maybe 15 of the 550 players in our league who will be able to qualify as coaches. The other 535 are going to have to go elsewhere. Most of these boys will consume from 6 to 8 months a year during training and making appearances on behalf of their team. It is very difficult to get a job from a leading institution and to do the job well in 4 months. And we have found the situation that when the boys come to the period of life when they have to go into commerce and compete with men, 5, 6, 8 years younger than themselves we feel if they would have something to supplement themselves, due to a small depletion as you say, a modest one which would be used up, at the end of 5 years, and that would be the end of it; that would be our career span.

Senator DOUGLAS. I have a great deal of sympathy with you as long as this principle is established. Let me ask you, however, nearly all of the professional football players have graduated from college, haven't they?

Mr. POSMANTUR. That is right, sir.

Senator DOUGLAS. In fact, one of the chief functions for colleges is to produce football players who are drafted, in other words, the colleges are markets where the teams draft the players into their service.

Well, now, having the college education they are not totally bereft of earning power, are they, when they terminate as athletes?

Mr. RETZLAFF. If I may be allowed to answer it using myself as a specific example, I have a master's degree in education qualified to teach.

Senator DOUGLAS. Yes.

Mr. RETZLAFF. I have been in the National Football League for 8 years and will probably stay another year.

Senator DOUGLAS. I watched you on television and I hoped to see you in person.

Mr. RETZLAFF. Thank you, sir.

If I were to go back now 10 years, let's say, after playing professional football and start in my first year of teaching as an educator, I would in no way qualify for any more than the minimum allowed

to me with a master's degree with no experience in teaching, and yet I have given up 10 years in professional football which I am not including as longevity in the teaching profession.

Senator DOUGLAS. In other words, you can earn more as a professional athlete than you can earn subsequently as a teacher.

Mr. RETZLAFF. Yes, sir.

Senator DOUGLAS. This raises a very interesting line of thought. I have been expecting this issue to come up for many years and indeed have helped it from time to time to come to the surface.

Poets are in much the same position. Poetic impulse develops early in life, and then there are very few poets who write good poetry after the age of 40. It is part of the ebullience of youth, so to speak. Shouldn't they receive a depletion allowance for the wasting away of their poetic inspiration?

Mr. POSMANTUR. Senator, again, we are not qualified to speak for the poets or their inspiration. However, I would like to say again——

Senator DOUGLAS. Moe Berg, who caught for some years in the major leagues, was a literary man, and we have a man now playing on one of the Chicago teams, Brosnan, who is a literary man, too, but they are not very common, so I can understand this is a little bit out of your field.

Senator MORTON. I would like to put in the name of Cassius Clay, he is my constituent.

Senator DOUGLAS. He, too. I thought the Senator from Kentucky would rise to the occasion.

Mr. POSMANTUR. Senator, just in answer to your question briefly, again I am going back to the situation with the actor. A poet, as a lawyer, or anyone in any field, can have two or three separate spurts in his life, as an actor. I have known actors who were great child actors and died off and they came back in the twenties and died again and they came back again 20 years later.

Senator DOUGLAS. Talk about a cat having nine lives; they have three lives.

Mr. POSMANTUR. Three or possibly, certainly, professional men and others have sometimes four or five different chances. The athlete really only has one. In all sincerity, we say these years are expended quickly, and the case of Pete Retzlaff is not unusual. He is a college graduate. In fact, he holds a master's degree but it would—he has had four children in the meantime, has been married some 11 years, and to get the same salary as a boy of 23 who had acquired a master's degree without maybe a wife, without those expenses or if one lesser due to the age of their families, is a most difficult thing that we are facing now, as the National Football League has become larger and of greater significance, and we have boys now reaching the stage in life where they are frankly in trouble.

Senator DOUGLAS. I have much more sympathy with you than I have with this 27½-percent depletion allowance on oil and gas, but in my judgment, if this oil depletion allowance is retained there is a good argument to provide depletion not merely for professional athletes, but for these other branches as well and I would like to broaden Senator Long's amendment so it would include moving picture actors or television personalities or poets.

Here is an interesting thing, too. Mathematicians generally do not do much good work after the age of 30. And there is another factor. When a man gets a Nobel Prize in science thereafter, except with Einstein, he makes no contribution to science. He gets the Nobel Price and then he lives on his laurels, and the flow of inspiration ceases.

So, I think we ought to provide depletion allowance for Nobel Prize winners, too.

Mr. Retzlaff?

Mr. RETZLAFF. I think perhaps the income averaging would take care of a person like that whereas the income averaging hardly would affect——

Senator DOUGLAS. I won't pursue this subject further. You can see I have been trying to attack the depletion allowance on oil and gas over your shoulders, so to speak.

Senator CARLSON. Mr. Chairman, Mr. Retzlaff, words fail me to express my appreciation for your appearance here this morning.

For years as one interested in the depletion on oil and gas, I have been trying to find some place to get a little spark of human sympathy, and kindness for that great industry, and the depletion allowance which helps it.

So, I feel this morning that we have found at least the human side of it. We may be able to convert him yet.

Mr. RETZLAFF. Thank you, sir.

Senator DOUGLAS. You are for the Long amendment, then?

Mr. RETZLAFF. I am for depletion.

Senator DOUGLAS. On human ability as well as——

Senator CARLSON. I have no objection.

Senator DOUGLAS. I think we ought to broaden this. The Senator from Kentucky.

Senator MORTON. I would like to ask one question.

In your testimony you talk about other income which results from endorsements of sports goods, I am thinking of in the professional golfer, for instance, in this case this is a source of income that goes beyond what he earns on the tournament circuit.

Is that the case of the professional football player? Is that generally sizable or is it limited to just a few of the outstanding players?

Mr. RETZLAFF. It is usually limited in the case of professional football players, sir, very few, and even at that the amount of money that those few derive is almost insignificant.

Personal appearances at a supermarket, at a toy store, or super department store of that sort probably would bring a ballplayer $50 to $75 for his appearance, and he may have 10 or 15 of these during the entire year, and the point that I tried to make there was that once a player is through as an active player along with his name goes his fame and consequently so goes this type of income, too.

Senator MORTON. I bring that question up for this reason, and I address this question to your counsel, it seems to me that this seriously might pose a problem with the possible adoption of the Long amendment.

I was wondering if it would be catastrophic if it were limited just to your purses or earnings directly, as direct compensation for participation in the sport rather than for these extra activities that

come about because of a fame achieved through the sport. I mean I think that you will find objection to the amendment with the inclusion of that language and I merely—I don't ask for you to answer now, but I would like to have you think that over.

Mr. POSMANTUR. We would be ready to answer that right now to this extent, of course, if it is the opinion of this committee after studying it that the depletions would be allowed for the actual on-the-field time which is the real basis of this.

However, in the case of these testimonials and endorsements it does bring up a little bit of income, not a large amount. You may be surprised to know that the average income of the NFL is less than $12,000 a year, and naturally that is an average, there are boys earning—the minimum wage is $5,000, isn't it—$5,000 a year, and I don't believe we have more than—we don't have a large amount earning over $20,000 in the entire league, and the extra $75 compounded by 10 or 15 appearances whatever you can get in between your working on another job, the best you can, if you can get those months, comes to maybe approximately $1,000 or $2,000, would be helpful but, of course, we would abide and support anything that this committee would come up with on this matter.

Senator MORTON. When we were discussing expense allowances, I took so many cruises on my good friend Senator Douglas' $500,000 yacht that I don't want to take too many trips on Arnold Palmer's endorsements as a weakening amendment.

That is all.

Mr. RETZLAFF. Thank you.

Senator DOUGLAS. Thank you very much, Mr. Retzlaff.

Mr. RETZLAFF. Thank you, gentlemen, for your courtesy.

Senator DOUGLAS. The next witness is Mr. Leonard Kandell, of New York, N.Y.

STATEMENT OF LEONARD KANDELL, NEW YORK, N.Y.

Mr. KANDELL. Gentlemen, my name is Leonard Kandell and the good news I have to bring to you is that I will talk for about 1 minute.

I just would like to tell Senator Douglas that I am a businessman and awfully tired and I think I have been depleted. Of course, I worked about 40 years but maybe you can include me a little bit. I am depleted, too.

Senator DOUGLAS. Would you draft an amendment to cover your case?

Mr. KANDELL. I will have that ready for you in 10 minutes, sir.

I just want to mention this: I came to Washington as a small businessman to point out how we were being hurt by the 6 percent penalty on multiple corporations, and how it will limit expansion and reduce our opportunities to create jobs. But I see that time is growing short. Others have made the point, and I know how valuable your time is. So, I will just leave it at that, and hope that you will consider it along with the other arguments that were made and thank you for the opportunity of being heard.

Senator DOUGLAS. Thank you very much, Mr. Kandell.

The final witness for the morning is Mr. Richard L. Reiner of Super Stores, Inc.

STATEMENT OF RICHARD L. REINER, SECRETARY-TREASURER OF SUPER STORES, INC.

Mr. REINER. I would like to say that being the time is growing late, I would like to try to go through it but it won't take but about 5 minutes.

My name is Richard L. Reiner. I am secretary-treasurer of Super Stores, Inc., with headquarters in Prichard, Ala.

I want to talk about the importance of the multiple surtax exemption to the growth and expansion of small business units. Because this is so vital to me and my company. I am especially appreciative of this opportunity to appear before you today to tell my story.

I am one of a group of three men who in 1955—just 9 years ago—got together $60,000 to start a small business. With such a small capital, we knew we faced plenty of tough, hard competition, both from existing local establishments and from local chains, and from the big national companies in our field such as F. W. Woolworth, S. H. Kress, and so forth.

We started with 14 employees. Today we are kind of proud to say we give employment to approximately 250 people in four Southern States, Alabama, Mississippi, Florida, and Louisiana. We have 24 stores and a warehouse, and we operate them through 10 separate but related corporations. Our net worth is approximately $400,000, and we got there by reinvesting annual earnings in our own business.

We have worked awfully hard to serve our customers and we have enjoyed a modest but steady growth. We feel we certainly are still small business.

Furthermore, our stores are small stores. They averaged less than $150,000 of annual sales per store in 1962. In 1961 when Congress extended the Federal wage-hour law to retail employees, it recognized that stores having annual sales of less than $250,000 were small stores and it provided that employees of such establishments need not be covered by provisions of that law.

At the same time, Congress also recognized that all such "under $25,000 stores" faced essentially the same operating expenses, competitive conditions, and marketing opportunities, whether they were locally owned or were part of a chain, and made no exception in exempting their employees if the store volume was less than $250,000.

I can assure you that our business needed not only this awareness of our problems, but the other assistance and encouragement which was and still possibly is available to us.

Highly important to our growth was the encouragement provided to us by the privilege of surtax exemption. It is my purpose in coming before you to tell you how the surtax exemption has helped us and how the restrictions and penalties which are now proposed in the House bill will affect the future of our small company.

As our operations expanded to other States from our original base in Mobile, Ala., we formed new corporations to facilitate the local acceptance of our business, to ease the handling of local and State laws and regulations of which there were many, and to avail ourselves of the opportunity of limiting our liabilities which fortunately we have not had to do up to this time.

When we began to grow in 1955, we planned our program in complete reliance on section 1551 of the tax code which had been enacted just a year before, in 1954.

It is my understanding that this section had received the most thorough consideration of the Senate Finance Committee and later the joint conference committee in 1951. The intentions of Congress were, in my opinion, expressed with utmost clarity.

Before coming here I read the report of the Committee on Finance, dated September 18, 1951. The Senate committee report took exception to the section (123) of the House bill which at that time sought to limit to one the number of surtax exemptions for a group of related corporations.

The Senate report objected on the grounds that the House bill would strike at bona fide corporate entities in the same manner it would treat cases of tax avoidance; that it would hurt corporations which were organized in the past for legitimate business reasons, and it said, and I quote, "especially in the case of small companies, it could result in a very substantial increase in tax liabilities."

As you know, the Senate committee in 1951 completely eliminated that provision of the House bill and strongly suggested that any future action to limit tax avoidance should aim at correcting the real cause of avoidance "without working a hardship on legitimate business organizations."

Subsequently, the conference committee reached agreement on what became section 1551, a statute which effectively prohibited the splitup of existing businesses, but did encourage legitimate expansion by providing the right to surtax exemptions for related corporations organized for valid business reasons.

Under present law a corporation which earns $25,000 or less pays a 30-percent tax rate, thus enjoying an exemption from the 22-percent surtax rate which applies only on earnings over $25,000. If a corporation earns as much as $25,000—most subsidiaries do not—very few of ours do unfortunately, its corporate tax liability is thus reduced by a maximum of $5,500 from what it would have to pay if the full 52-percent corporate rates were applicable.

I can assure you that the availability of this cash has been highly essential to our ability to reinvest enough of our earnings so that we can continue to grow. The original proposal made by the Treasury Department early this year was virtually the same one that was rejected by the Senate Finance Committee in 1951. It would have permitted us only one $25,000 surtax exemption for our entire business and thus would have substantially increased our tax liability.

I am, of course, relieved that the House Ways and Means Committee again rejected such a suggestion. However, H.R. 8363, as passed by the House of Representatives, although it lowers the tax rates, would not give the needed assistance to our concern and other similar small businesses.

The Treasury Department has now apparently convinced a majority of the House Ways and Means Committee that an interchange of normal and surtax rates cannot be contemplated unless there are severe deterrents to keep the proposed lower corporate rate from inducing a lot more businesses to organize in a separate corporate structure. This seems to me to be the crux of the argument which is being

used to justify penalties which will be very detrimental to our type of business.

The House bill would reduce the normal rate to 22 percent on the first $25,000 of earnings by any of our separate corporations. But an additional 6 percent tax would be levied on each of them and this would make our direct rate not 22 but 28 percent.

Corporations, large or small, public or private, have stockholders who have invested funds with them, we are proud we have less than a hundred of which 35 are employees.

To get a return on his investment, a stockholder looks to dividends. The parent company must declare the dividend and to do so it must have the funds available. These funds depend on the earnings of the separate stores. When those stores have earnings, they may declare a dividend to the parent. In doing so they are required to pay a tax on 15 percent of such earnings passed to the parent in dividend form. Based on the proposed rates, this would add an additional tax of a little over 5 percent even on the first $25,000 of earnings. H.R. 8363 made no change in this already existing tax on intercorporate dividends. It has been there and it is left.

As a result, businesses such as ours could be burdened with a total tax penalty of over 11 percent, which could bring the total rate on the first $25,000 of earnings of one of our stores to 33 percent.

Section 223 of the House bill contains these words:

> The tax structure was intended to encourage small businesses which operate in corporate form.

As far as our small business is concerned, an effective tax rate of 33 percent is far from encouraging, especially when many one-store competitors operating the same kinds of stores would be paying only a 22-percent rate.

It is very difficult for us to understand why our business should now be penalized, and our earnings impaired with a possible inhibition of future growth. We have organized our business through several related corporations for sound business reasons in full reliance on the provisions of the present law. As far as we can see elimination of the proposed penalties would not give us any advantage over any of our competitors.

We feel our modest and steady growth can be attributed to the hard work and long hours put in by, not by just a few of us, but by all members of our firm which has created customer acceptance and by having each of our stores operate as part of the community in which it is located, using local people and local facilities whenever and wherever possible.

Actually, if I may add there, the most out-of-towners we have in most of our stores is one. We have no stores where we have more than one out-of-towner who has been brought into the community.

Certainly the surtax exemptions give us no undue advantage over the single store owner. He could have done just as we did in availing himself of the encouragement to growth intended and provided by the law. If the single store owner did not do so, perhaps instead he chose to invest his available funds in some other manner—in real estate, in General Motors stock or his own bank account, many other places.

My associates and I chose to reinvest our available funds in the future of our own business. We expect to continue to plow back earnings but we have reached the point where at least modest dividends ought to be paid.

Again, may I say we have never paid a cash dividend and I personally on my net worth, 93 percent of my net worth is in stock in my company.

The surtax exemptions do not give us an advantage over the big national, retail companies—the J. C. Penneys, the A. & P.'s, the Sears-Roebucks, and the Woolworths and others that we could mention. On the contrary, the surtax exemption is one of the only ways in which a small company like ours can compete with these powerful organizations.

Those strong competitors of ours had their greatest growth many years ago at a time when corporate tax rates either were nonexistent or represented far less of an expense than they do today. The slight reduction in corporate rates which is now under consideration does not near begin to create the same kind of tax climate that existed in the days when the retailing giants were developing.

These aforementioned large companies have the advantage of long-established and well-known names. Consequently, they are offered lease terms with rentals somewhat lower than anything we can negotiate. This is understandable since the presence of such establishments with national credit ratings and unmistakable traffic-creating power in a shopping center makes it possible for the developer to obtain adequate financing for completion of the development.

As a matter of fact, most of the large retail firms such as those I have mentioned, do not use the multiple surtax exemption privilege, to the best of my knowledge. They don't use it, I am sure, for the simple reason that it offers no tax advantage to such companies because of their high volumes and profits per store or per area, the effect of intercorporate dividends, and the complexities that would be involved in a multiple-corporation setup for large companies.

Again, I would like to add there, you take our strongest competitor in the field, Woolworth Co., with 2,200 stores, we just have 10 corporations with 24 stores and we have quite a time keeping them separated to the true extent and keeping track of them from the accounting standpoint and with 2,200 I don't know how they do it. I can't imagine.

I hope this helps to clear up what I think is a seriously wrong impression. The multiple-surtax exemption privilege, as we see it, does not and will not give additional advantage to the giant companies in retailing. The encouragement it offers is meaningful in retailing only to operators of rather small establishments—small stores specializing in apparel, in jewelry, in clothing, and small variety businesses such as ours which are trying earnestly to provide the smalltown customers with good values, good selections, and good service.

We are certainly in accord with the expressed purpose of the House bill to encourage small businesses which operate in corporate form.

However, our own business would be severely prejudiced by enactment of the multiple surtax penalties in H.R. 8363. I am certain that the facts and the reasons which apply to our company are equally applicable to other small retailers all over America. On many Main

Streets and in small courthouse towns there are young and ambitious merchants who want to grow. They need at least as much encouragement as we had 9 years ago when we made our decision. The record, as we see it, proves that the present law on the surtax exemption and the permitted transfer of corporate earnings has accomplished and continues to accomplish the purpose intended.

Small business has been given a special opportunity to grow. In retailing this applies beneficially to relatively small stores units—those with gross sales substantially less than $400,000 annually, I use that figure because we don't have a store over that figure and we know what our problems are with them, we think.

These small stores, the backbone of distribution, are typically not the province of giants but are the opportunity for us small merchants. We have seen or heard about no abuses of this tax consideration by companies whose stores are entitled to surtax exemptions and are led to the observation that if there are any, they are relatively few and minor.

On the plus side, companies like mine have been helped to grow. In view of the record I hope you will agree with me that the 6-percent penalty on the earnings of each corporation in a multiple corporate setup is not a needed, desirable, or wise fiscal policy and would be harmful to our economy.

Thank you for giving me the chance to be heard.

Senator DOUGLAS. Thank you very much.

Senator Carlson?

Senator CARLSON. I have been requested by the chairman to insert this statement in the record at this point.

(The statement referred to follows:)

STATEMENT BY SENATOR HARRY F. BYRD, DEMOCRAT, OF VIRGINIA, DECEMBER 5, 1963

In my interview with the President today we discussed very fully the details of the next budget and likewise the tax reduction bill.

I explained to him that the tax reduction bill was progressing in an orderly fashion and that it would be reported to the Senate after a markup of the 28 pending amendments and then the bill itself.

The executive sessions will start on December 11, and the bill will be reported to the Senate by regular procedure.

The President indicated that in view of the conditions existing this was satisfactory to him, although he would have preferred earlier action.

He then assured me that the budget, providing for the next fiscal year spending, would be presented to the Congress before the tax bill was finally enacted. This is what I have been urging since the tax bill was introduced.

He indicated that he would cut the cost of Government in every possible way. I was impressed by his knowledge of Federal expenditures, and I am sure he is making a thorough study.

He said further that before submitting the budget he would discuss it with the chairman and ranking members of both the Finance Committee and the Ways and Means Committee of the House.

From the time the tax bill was introduced, I have contended that the sound method of handling an $11 billion tax reduction with a planned deficit is that the Congress should have knowledge of the budget to be submitted in January before final action was taken on the tax legislation. This the President assured me was satisfactory to him.

I strongly urged the President to reduce the budget in every possible way and made it clear to him that I could not vote for the tax reduction bill unless the line is held against budget increases.

Senator DOUGLAS. We will meet on Monday at 10 o'clock.

(By direction of the chairman, the following is made a part of the record:)

MARYLAND STATE FEDERATION OF
BUSINESS & PROFESSIONAL WOMEN'S CLUBS, INC.,
Marriottsville, Md., December 2, 1963.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SIR: The Maryland Federation of Business & Professional Women's Clubs wishes to endorse the amendment to H.R. 8363 offered by Senator Neuberger.

We feel that the present limit on deductions for child care is very unrealistic in the light of prevalent wages. We also think that the limitation on income required for allowance of such deductions should be raised.

Most mothers work because they have to do so in order to maintain the family. Under the present low limits it is the children who are suffering from lack of proper care and/or necessities. Our Nation cannot afford such deprivation for its children.

We earnestly request your support of Senator Neuberger's amendment.

Sincerely yours,

MARGARET A. BOWERS,
Legislation Chairman.

KENTUCKY FEDERATION OF
BUSINESS & PROFESSIONAL WOMEN'S CLUBS,
Radcliff, Ky., December, 2, 1963.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Kentucky Federation of Business & Professional Women's Clubs, representing 73 clubs in Kentucky, heartily endorses the proposed amendments by Senator Neuberger to the bill, H.R. 8363. We urge the adoption of these amendments.

Mrs. MARY N. JOHNSON,
State Legislation Chairman.

SOUTH DAKOTA STATE FEDERATION OF
BUSINESS & PROFESSIONAL WOMEN'S CLUBS, INC.,
Flandreau, S. Dak., December 2, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Building, Washington, D.C.

DEAR SENATOR: Senator Neuberger has made proposed amendments to bill H.R. 8363, which pertains to the Internal Revenue Code of 1954.

Since this is one of the action support items covered in the national legislative platform of Business & Professional Women's Clubs, Inc., the South Dakota organization is vitally interested in supporting this legislation.

As State legislative chairman, I understand that there will be a Senate Finance Committee hearing on December 6, on this matter, and we ask your active support of this measure. Any help or cooperation which we may give will be forthcoming should you wish it.

Yours sincerely,

Mrs. EDITH STOKES,
State Legislation Chairman.

THE HAWAII FEDERATION OF BUSINESS AND PROFESSIONAL WOMEN'S CLUBS,
Honolulu, Hawaii, November 28, 1963.

Re proposed amendments to H.R. 8363.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: Our national president, Miss Virginia Allan, will present a statement in support of Senator Neuberger's amendments to the bill, H.R. 8363, on December 6, 1963. The Hawaii State Federation of Business & Professional Women's Clubs joins Miss Allan in urging your support of these proposed amendments.

This increase in the maximum deduction for child care is made even more meaningful when it is considered that among married women, one in three is working; among nonwhites, almost one in two. The 13 Hawaiian Business & Professional Women's Clubs unite with the 170,000 business women in our national organization to earnestly recommend your active, affirmative action on Mrs. Neuberger's amendments and your expeditious handling of the entire internal revenue revision bill, H.R. 8363.

Sincerely yours,

MARY ELLEN SWANTON,
Legislative Chairman.

OHIO FEDERATION OF BUSINESS AND PROFESSIONAL WOMEN'S CLUBS,
Dayton, Ohio, December 3, 1963.

Re proposed amendments to H.R. 8363.

Senator HARRY F. BYRD,
Senate Office Building, Washington, D.C.
Chairman, Senate Finance Committee,

DEAR SENATOR: We understand that the above subject matter is to be heard on the floor of the Senate within the next few days.

The Ohio Federation of Business and Professional Women's Clubs is in favor of the proposed amendment, as well as the national federation, and we solicit your active support of this measure.

Yours very truly,

LILLIE B. SALZWEDEL,
Chairman Legislation Committee.

RENO BUSINESS AND PROFESSIONAL WOMEN'S CLUB,
Reno, Nev., December 2, 1963.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SIR: The members of the Reno Business and Professional Women's Club request your support of the proposed amendment by Senator Neuberger to bill H.R. 8363.

This bill with the proposed amendment is covered by A of item 11 of the national legislative platform of the business and professional women and should have the support of all of the clubs and State federations in the United States.

Thank you for your cooperation.

Yours very truly,

PEARL O'BOYLE,
Legislative Chairman.

NEW JERSEY FEDERATION OF BUSINESS AND PROFESSIONAL WOMEN'S CLUB, INC.,
Westfield, N.J., December 2, 1963.

Hon. HARRY F. BYRD,
Chairman of Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: On behalf of the New Jersey Federation of Business and Professional Women's Clubs, Inc., and personally, I request that you support the amendments proposed by Senator Neuberger to the bill, H.R. 8363, an act to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes.

The taxpayers who will be affected by the proposed amendment are entitled to consideration, particularly by reason of the fact that in order to earn the additional income they are subjected to additional costs peculiar to them, namely, cost of child care and dependents.

Thanking you for your consideration and support, we are,

Very truly yours,

EMMA C. MCGALL,
State Legislation Chairman.

CENTRAL NATIONAL LIFE INSURANCE CO.,
Jacksonville, Ill., October 21, 1963.

Hon. PAUL H. DOUGLAS,
Senator from Illinois,
Senate Office Building, Washington, D.C.

DEAR SENATOR DOUGLAS: The Senate Committee on Finance now has pending before it the President's tax bill, H.R. 8363, which was only recently passed by the House of Representatives. There are many provisions in that bill which relate to the eligibility of transactions for capital gains treatment. I understand that the entire area of capital gains was extensively reviewed by the House Ways and Means Committee when it considered H.R. 8363.

The purpose of this letter to you is to request your support of a captail gains amendment to H.R. 8363, the consideration of which was overlooked by the Ways and Means Committee when it reviewed the eligibility of other transactions for capital gains treatment.

The amendment I am referring to is contained in S. 2154, introduced by Senator Russell Long of Louisiana on September 18, 1963. As was explained in Senator Long's statement when he introduced the bill, the purpose of S. 2154 is to accord equity to small mutual insurance companies and life insurance companies so that they may be taxed on gains from bonds purchased at less than par value in the same manner as all other taxpayers are taxed.

All other taxpayers are taxed at capial gains rates on market profits realized from purchasing bonds at less than face value when the bond is sold or redeemed. Small mutual insurance companies and life insurance companies, however, are not entitled to treat their bond discount profits as capital gains because the present Internal Revenue Code provisions require them to accrue a pro rata portion of the discount each year instead. Other taxpayers are not required to accrue their bond discount in this manner.

S. 2154 removes the required accrual of bond discount by small mutual insurance companies and life insurance companies for years after 1962, thereby according them the same capital gains treatment on the sale or redemption of bonds purchased at a discount as is given all other taxpayers.

Senator Long's bill eliminates this discrimination against small mutual insurance companies which apparently was overlooked last year when the mutual insurance company tax provisions were revised. At that time medium and large mutual companies were given capital gains treatment on bond discount but similar treatment was not provided for the smaller mutual companies.

Similarly, S. 2154 corrects this inequity for life insurance companies. This matter was also overlooked when the life insurance company tax provisions were revised in 1959.

I would very much appreciate it if you would refer my letter to Senator Byrd, chairman of the Finance Committee, and have it included in the hearings on H.R. 8363 so that the committee may consider this matter when it reviews the bill.

For your information, Senator Long's bill is S. 2154, and his explanatory

statement from pages 16451–16452 of the September 18, 1963, Congressional Record.

I am interested in this matter merely because it will correct any inequities in the present situation.

With best wishes and personal regards.

Sincerely,

RICHARD YATES ROWE,
President.

NEVADA FEDERATION OF BUSINESS AND
PROFESSIONAL WOMEN'S CLUBS,
Las Vegas, Nev., November 27, 1963.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

SIR: I am writing on behalf of the 300 members of the Nevada Federation of Business and Professional Women's Clubs to request your support of the proposed amendment by Senator Neuberger to bill H.R. 8363.

Yours very truly,

DORIS GRAGG, *Legislative Chairman.*

(Submitted by A. N. Overby, Chairman, Foreign Investment Committee)

INVESTMENT BANKERS ASSOCIATION OF AMERICA

SUMMARY EXCERPTS FROM MEMORANDUM IN OPPOSITION TO THE ENACTMENT OF H.R. 8000 (THE PROPOSED "INTEREST EQUALIZATION TAX ACT OF 1963")

1. The improvement in the balance of payments resulting from the threat of the proposed tax is misleading.

The uncertainty engendered by the threat of the enactment of a retroactive tax has in effect imposed not merely a limitation but an actual embargo on the sale of new foreign securities in the U.S. capital market.

2. The method used by the U.S. Government in determining its balance-of-payments deficits tends to exaggerate the seriousness of the U.S. position.

Since 1950, the first postwar year in which a deficit in the U.S. balance of payments appeared, the overall net international asset position of the United States has improved from $14 to $33 billion.

3. The proposed tax will adversely affect the U.S. balance of payments in the long run.

Private foreign investment is an asset creating expenditure. The extent to which income from previous investments serves to offset current net capital outflows is indicated by the fact that * * * in 1962 alone income amounted to $3,850 million as compared to a net outflow of $3,273 million. Trade follows credit. Purchases by foreigners of our exports of goods and services with dollars obtained from U.S. purchases of foreign securities * * * provide jobs for Americans. Moreover, future receipts from foreign investments in the form of interest, dividends, and return of capital benefit the balance of payments in future years.

4. The proposed tax is not addressed to the fundamental causes of the balance-of-payments deficit.

To reduce significantly our balance-of-payments deficit we must * * * reduce the direct dollar drain from military expenditures abroad, * * * make greater progress in relating foreign economic assistance * * * to expenditures of dollars in the United States, * * * improve our cost position in relation to our competitors abroad, and * * * increase the attractiveness of foreign direct and portfolio investments in the United States by reduction in income taxes and other appropriate measures.

5. The proposed tax is a new protective tariff on capital transactions and is inconsistent with our longstanding policy of freedom for capital movements.

6. The U.S. capital market, and foreign economies dependent upon it, may be seriously damaged.

7. The proposed tax creates fears of further restrictions.

We must not, through one device or another, impair the value of the dollar as the key currency of the world or create fears that further restrictions may be imposed.

8. The proposed tax is discriminatory.

It selects only * * * private portfolio investments for restriction through a special tariff while leaving unaffected private expenditures abroad for tourism, direct foreign investment, and commercial bank loans.

9. The proposed tax is administratively complex.

Compliance and enforcement procedures will prove burdensome. * * *

MEMORANDUM IN OPPOSITION TO THE ENACTMENT OF H.R. 8000 (THE PROPOSED "INTEREST EQUALIZATION TAX ACT OF 1963")

1. The improvement in the balance of payments resulting from the threat of the proposed tax is misleading.

The Department of Commerce has reported that the deficit in the U.S. balance of payments in regular transactions was $721 million in the third quarter of 1963 as compared with $1,201 million in the second quarter. Transactions directly affected by the proposed tax (i.e., purchases of new foreign securities and net purchases of outstanding foreign securities) resulted in a net outflow of $171 million in the third quarter as compared to $572 million in the second quarter. Short-term bank loans, which are not restricted by the proposed tax, changed even more sharply from a $394 million net outflow in the second quarter to a $95 million net inflow in the third quarter.

These third-quarter balance-of-payment figures should not be taken as a reliable basis for determining the effectiveness of the tax in improving the U.S. balance-of-payments position.

In the first place, as Secretary of the Treasury Dillon himself recognized in his October 21, 1963, opening statement before the executive session of the House Ways and Means Committee, "The initial impact of the tax on negotiations between potential lenders and borrowers has been exaggerated by a tendency to postpone action pending legislative resolution of the proposal." The fact is that the uncertainty engendered by the threat of the enactment of a retroactive tax has in effect imposed not merely a limitation but an actual embargo on the sale of new foreign securities in the U.S. capital market. The U.S. capital market for new foreign issues has for all practical purposes been closed down by executive fiat.

Secondly, the consequential reductions in U.S. net exports to important trading partners such as Canada and Japan, which depend in large measure on U.S. private capital investment to finance their trade deficits with the United States, have not yet had time to manifest themselves significantly.

Thirdly, the reduction in the rate of growth in U.S. receipts from interest and dividends corresponding to the decreased private foreign investment has also not yet been reflected in any significant degree in the third quarter figures.

Fourthly, the proposed exemption for Canadian new issues, which alone amounted to $457 million in 1962 and to $632 million in the first 6 months of 1963, has not yet become operative.

2. The method used by the U.S. Government in determining its balance-of-payments deficits tend to exaggerate the seriousness of the U.S. position.

As pointed out in the report of the Brookings Institution on "The U.S. Balance of Payments in 1968," prepared at the joint request of the Council of Economic Advisers, Secretary of the Treasury, and the Bureau of the Budget, the sum of a country's international payments must be equal to the sum of its receipts and the only basis for arriving at a deficit is by excluding certain payments and receipts and treating them as financing or balancing items. In the case of the U.S. balance of payments, "deficits are, by definition, whatever is financed by a combination of sales of U.S. monetary reserve assets and increases of U.S. liquid liabilities to foreign governments and monetary authorities and to private citizens of foreign countries." Such deficits do not involve a reduction in the total net foreign assets of the United States. On the contrary, since 1950, the first postwar year in which a deficit in the U.S. balance of payments appeared, total U.S. assets and investments abroad have increased from $32 to $80 billion while foreign assets and investments in the United States increased from $18 to $47 million. Thus, the overall net international asset position of the United States has improved from $14 to $33 billion. The total reported balance-of-payments deficits have represented only a reduction of net U.S. foreign assets

in liquid form and, as further pointed out by the Brookings report, reflect a special view of what constitutes liquid assets since only monetary reserve assets in official U.S. Government hands are included. Thus, short-term foreign assets owned by U.S. private citizens are not included even when held in countries with convertible currencies and their acquisition thus contributes to the deficit. Moreover, U.S. liquid liabilities are defined to include foreign holdings of most long-term U.S. Government securities.

3. The proposed tax will adversely affect the U.S. balance of payments in the long run.

Private investment abroad and the growth of such investment through retained earnings, increases in value and other factors improve the international assets position of the United States. As shown under (2) above, the improvement in the U.S. overall international net asset position since 1950 has been from $14 to $33 billion. Moreover, future receipts from foreign investments in the form of interest, dividends, and return of capital benefit the balance of payments in future years. Accordingly, considered from the standpoint of the U.S. international asset position and long-term balance-of-payments position, private foreign investment is an asset-creating expenditure.

The extent to which income from previous investments serves to offset current net capital outflows is indicated by the fact that in the 5 years 1958 to 1962 income from all private foreign investment amounted to $15,419 million as compared to an aggregate net outflow for new investment of $16,626 million. Moreover, in 1962 alone income amounted to $3,850 million as compared to a net outflow of $3,273 million.

Official statistics do not separate the income from private foreign investment of the portfolio type as between that which arises from long-term and that which comes from short-term capital investments, but the total for the two combined in 1962 was $800 million and it seems reasonable to attribute at least $600 million of this to long-term private portfolio investments. This is a direct offset in the balance of international payments against the roughly $1.1 billion net outflow of long-term private capital, other than direct investment, in 1962.

Trade follows credit. Purchases by foreigners of our exports of goods and services with dollars obtained from U.S. purchases of foreign securities also offset the balance-of-payments impact of long-term private portfolio capital outflow. In many cases the connection is direct and the proceeds of foreign securities issues have been used to buy specified U.S. goods and services and provide jobs for Americans. For example, in 1959 KLM Royal Dutch Airlines offered and sold in the United States $18,500,000 of debentures for the purpose of acquiring jet aircraft from U.S. manufacturers. Also in 1959, the Italian chemical company, Montecatini, offered and sold in the United States $10 million of debentures to finance the construction of a chemical plant near Huntington, W. Va. More recently K.D.D., the Japanese oversea telephone company, privately placed $25 million of notes for the purpose of paying for U.S. equipment and the services of an American cable-laying ship.

The chance that dollars spent to buy foreign securities will find their way back to the United States, and find it promptly, in the purchase of our exports is greatest, of course, in the case of countries that are not in the position of accumulating dollar reserves, that is of deficit or near-deficit countries. Canada and Japan, which themselves accounted in 1962 for slightly more than half of the new issues floated in U.S. capital markets ($558 million of a total of $1,076 million), are such countries.

The coauthor of the Brookings Institution study, Prof. Emile Despres, of Stanford University, in his testimony before the congressional Joint Economic Committee on July 29, 1963, made the following statement with respect to the effect of the proposed tax as applied to Canadian and Japanese securities:

"* * * it probably won't help our balance of payments, and indeed it may have the opposite effect because Japan and Canada are countries that have operated on rather modest reserves relying upon the United States, being financially dependent upon us in a sense to tide them over balance-of-payments difficulties.

"To the extent that it causes them to feel that this is no longer available to them as readily, it may cause them to adopt economic policies which will result in the holding of larger reserves, probably at the expense of the U.S. reserves. In other words, the adaptations which these countries will make to less ready access to our capital markets are likely not merely to compensate but to overcompensate, and therefore the balance-of-payments advantage when we try to apply it to countries like Canada and Japan is likely to be nil or negative."

In the case of European countries we have a two-way flow of long-term private capital funds: U.S. citizens and businesses buy securities from Europeans and Europeans buy securities from U.S. persons. And of late these two flows have come very close to balancing out, with the result that our long-term private capital transactions with Europe make no significant contributions to the imbalance in U.S. international payments.

Data published by the U.S. Treasury show that purchases from U.S. persons of securities by Europeans in the first 6 months of 1963 came to $1,713,839,000 as against sales to U.S. persons by Europeans of $1,7[illegible]0,083,000, leaving a net negative effect in the balance of payments of only $26,244,000. In the 5 years 1958 through 1962, total European purchases of securities from U.S. persons exceeded total U.S. purchases of securities from Europeans by $280 million.

4. The proposed tax is not addressed to the fundamental causes of the balance-of-payments deficit.

To reduce significantly our balance-of-payments deficit we must get at the real bases of the dollar outflow: (*a*) we must lose no opportunity constructively to reduce the direct dollar drain ($2.4 billion net in 1962) from military expenditures abroad; (*b*) we must make greater progress in relating foreign economic assistance (which adversely affected the balance of payments to the extent of about $1 billion in 1962) to expenditures of dollars in the United States and in persuading other developed countries, especially those which are reserve accumulating, to assume a larger share of foreign assistance programs; (*c*) we must improve our cost position in relation to our competitors abroad; and (*d*) we must increase the attractiveness of foreign direct and portfolio investment in the United States by reduction in income taxes and other appropriate measures.

The general conclusion of the Brookings study is that the deficit in the U.S. net basic balance (which excludes short-term capital flows) will be eliminated by 1968 and that there is a definite possibility that a significant basic surplus may develop. The Brookings report cites two major reasons why—on the basis of its initial assumptions as to relative growth rates, price levels, and other relevant factors—this projected improvement will occur: "The first is that * * * prices and costs in Western Europe, primarily on the Continent, will rise substantially relative to prices and costs in the United States. The resulting improvement in the competitive position in the United States, together with the expected rise in Western Europe's real income, will increase the excess of U.S. exports over U.S. imports of goods and services other than investment income. Second, a number of factors will combine to increase the excess of interest and dividend receipts over net outflow of private long-term capital. These factors will be reinforced by expected policies with respect to U.S. military expenditures abroad." The report also points out that cuts in military expenditures abroad will have more effect per dollar on the balance of payments than cuts in economic aid, because they can be and are largely directed toward Western Europe, a dollar accumulating area.

Finally, it should be noted that the United States is by no means without resources for meeting the dollar drains to which it is subject. They consist of (*a*) official holdings of gold and foreign exchange; (b) formal "swaps" of currency or similar bilateral arrangements; (c) the issuance of special certificates and bonds denominated in the currency of the creditor country; and (*d*) access to the International Monetary Fund.

These resources provide defenses that permit a deficit country to deal with substantial pressures without imposing new restrictions, and to apply the basic corrections that are needed to bring international payments into reasonable balance. Moreover, if any more drastic temporary measures were required, we would question whether interference with asset-creating portfolio investment abroad is warranted when no significant steps have been taken to reduce non-asset-producing private expenditures, such as American tourists' expenditures in foreign countries (which amounted to nearly $2½ billion in 1962).

5. The proposed tax is a new protective tariff on capital transactions and is inconsistent with our longstanding policy of freedom for capital movements.

The proposed tax would be more accurately described not as a tax at all but rather as a new protective tariff to limit the importation of foreign securities or, viewed from the opposite point of view, as a duty on exports of private capital for portfolio investment abroad. So viewed, the so-called tax represents a new barrier to the free international movement of capital and a retreat from the policy, followed in the postwar years by Democratic and Republican administrations alike, of maintaining and advocating the free flow of capital across national borders.

6. The U.S. capital market, and foreign economies dependent upon it, may be seriously damaged.

The position of the United States as the only free capital market in which the amount and terms on which an issuer can sell its securities are limited solely by the marketplace is a precious national asset which should not be dissipated without convincing reasons of national interest. Because of this position, the United States has in effect become the banker for the free world and has attracted a large volume not only of domestic U.S. capital but also of foreign capital.

In the international competition with socialism the importance to capitalism of a free international capital market to which private enterprise might turn for private financing cannot be overestimated. In the light of the dependence which a number of foreign countries with economies such as those of Canada and Japan have placed on the private U.S. capital market in meeting their financial requirements, the temporary demoralization of the securities markets in these countries when the proposed tax was announced is clearly understandable.

7. The proposed tax creates fears of further restrictions.

The United States today is the leading financial power of the world. We all want it to remain so. Part of the responsibility and obligation of being the leading financial power of the world—of being the banker to the world and of having the key currency which is widely recognized as a standard of value and widely used in world trade and finance—is to keep our currency strong and free from restrictions on its use. We must not, through one device or another, impair the value of the dollar as the key currency of the world or create fears that further restrictions may be imposed.

8. The proposed tax is discriminatory.

The proposed tax is broadly discriminatory since it selects only one aspect of private expenditure abroad; namely, private portfolio investment, for restriction through a special tariff while leaving unaffected private expenditures abroad for tourism, direct foreign investment, and commercial bank loans made in the ordinary course of the bank's commercial banking business.

9. The proposed tax is administratively complex.

It will be applicable not merely at the time of the original issuance of securities but to subsequent nonexempt transactions throughout the life of the tax. Certificates of American ownership must be employed to qualify for the prior American ownership exemption and transactions even in foreign securities qualifying for this exemption must be reported in quarterly tax returns. Compliance and enforcement procedures will prove burdensome both for the security dealers of the Nation and ultimately for the Treasury itself. Policing compliance, particularly where bearer securities are involved, may be exceptionally difficult.

The Investment Bankers Association believes that the proposed Interest Equalization Tax Act should not be enacted. Any probably short-term beneficial effects fall far short of justifying the adverse consequences. It is most injurious to the U.S. international capital market, a national asset to be fostered rather than injured. It imposes hardships on our friends abroad that over the long term can only be detrimental to us as well.

Our long-term balance-of-payments position and outlook is strong. It would be better to deal with our present problem by improving our international competitive position, encouraging increased foreign investment in the United States, reducing our non-asset-creating expenditures abroad and even by temporary drawings on the International Monetary Fund or use of our reserves rather than to endanger the free flow of funds or our position as the world's banker and trustee of the key currency of the world. Once confidence in us and in the freedom of our capital market is impaired, it will be difficult to rebuild it.

Statement of the Federal Taxation Committee, Investment Bankers Association of America, Re H.R. 8363—Revenue Act of 1963

The following statement is submitted on behalf of the Investment Bankers Association of America. We respectfully request that it be considered and included in the printed record of the current hearings on H.R. 8363.

The Investment Bankers Association of America is a voluntary, unincorporated trade association of investment banking firms and securities dealers and brokers who collectively underwrite, deal, and act as brokers in all types of securities.

The association has about 760-member firms engaged in the securities business in the United States and Canada, including about 100 commercial banks. Our members have, in addition to their main offices, about 2,100 registered branch offices.

At the hearings held earlier this year by the Ways and Means Committee of the House of Representatives on President Kennedy's 1963 tax message, the association, through its Federal taxation committee, submitted a statement to the committee commenting in considerable detail upon a number of the President's tax proposals. The text of this statement is contained in part 5 of the printed hearings before the Ways and Means Committee on the tax message, at 2812. As most of the proposals on which we commented are embodied, in modified form, in H.R. 8363, and as our earlier statement is thus available to your committee, we shall not repeat those comments here but shall, rather, address ourselves to several provisions of H.R. 8363 which are of particular concern to the members of our association and, indeed, to the securities industry generally.

THE PROPOSED RATE REDUCTIONS—BOTH CORPORATE AND INDIVIDUAL

First, some general observations. As indicated in our statement to the Ways and Means Committee, we want enthusiastically to endorse and aline ourselves with the following opening statements in President Kennedy's 1963 tax message to the Congress and the goals of this program:

"The most urgent task facing our Nation at home today is to end the tragic waste of unemployment and unused resources, to step up the growth and vigor of our national economy, to increase job and investment opportunities, to improve our productivity, and thereby to strengthen our Nation's ability to meet its worldwide commitments for the defense and growth of freedom. The revision of our Federal tax system on an equitable basis is crucial to the achievement of these goals * * * it has become increasingly clear—particularly in the last 5 years—that the largest single barrier to full employment of our manpower and resources and to a higher rate of economic growth is the unrealistically heavy drag of Federal income taxes on private purchasing power, initiative, and incentive. Our economy is checkreined today by a war-born tax system at a time when it is far more in need of the spur than the bit."

We also enthusiastically subscribe to the proposed declaration by Congress, in section 1 of the bill, that "It is the sense of Congress that the tax reduction provided by this act through stimulation of the economy, will, after a brief transitional period, raise—rather than lower—revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. To further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective."

We strongly recommend that the tax rate reductions, both corporate and individual, proposed by this bill, or any modifications thereof deemed appropriate by your committee, be made effective as of January 1, 1964.

We are not unmindful of the budget and other implications of this implications of this recommendation and so we should like to make a few general observations in this area. As indicated in our statement to the Ways and Means Committee, we would not favor immediate tax reduction if this in turn automatically would mean a Federal budget deficit which would have to be financed by expanding the money supply and creating another inflationary spiral. Such a result would, of course, in the long run, defeat the worthy objectives of the proposed tax reduction. We note, however, from the report of the committee on H.R. 8363 that, taking into account the Treasury Department's estimate of the stimulative effect of the proposed tax reduction, the bill is expected to reduce revenues by $1.8 billion in fiscal year 1964, and $3.5 billion in fiscal year 1965.

We have had assurances from our monetary, fiscal, and debt management authorities that such increases in these deficits can be financed outside the banking system and in a noninflationary way. The splendid record of our debt managers and monetary authorities over the past few years would indicate that this can be done, and without undue impact upon our international balance-of-payments problem. These authorities have indicated that they have every intention of so handling any deficit involved. Under these conditions, we are willing to take such risks as are involved for the benefits we think will flow

from getting corporate and individual tax rate reform commencing January 1, 1964.

We are convinced that if such a program is enacted into law, effective January 1, 1964, even though covering a 2-year period, businessmen and others could better plan for the future. We believe that the overall effect of such a program would aid in creating a tax atmosphere generally which would be conducive to consumption, investment, economic growth and the creation of new jobs, even before all of its provisions go into effect.

THE RATE SCHEDULES

With respect to the specific rate reductions contained in H.R. 8363, our basic view is that almost any reduction in our presently repressive tax rate structure would be better than no reduction at all.

We heartily approve of the proposed tax rate reduction for corporations from 52 to 50 percent in 1964, and from 50 to 48 percent in 1965 and recommend its adoption. This is long overdue, and we wish it could be more. Such corporate rate reduction should certainly tend to increase corporate profits and thus, in turn, savings, new job-producing investment, and economic growth.

The proposed individual tax rate structure in the bill, ranging from 14 to 70 percent, as distinguished from the present 20 to 91 percent, should, likewise, encourage not only additional consumption but, also, job-producing investment. It offers greater rewards for initiative, for the creative person, the risk taker, and the doer. At the same time, in light of our experience, working daily as we do with investors and corporate management, we feel that a rate reduction formula which would, over a given period, bring the top individual rates below 50 percent, and which has greater thrust in the tax brackets where initiative, incentive, savings, and investment can most directly be stimulated, would better achieve the overall objectives of the bill than the tax rate structure contained therein. We have long felt, and so stated, that a person or corporation must be permitted to keep at least 50 percent of his or its income if we are really concerned about equity, incentive, initiative, savings, and new job-producing investment. We nevertheless approve the individual tax rate structure proposed in H.R. 8363 as a step in the right direction and urge its adoption.

PROPOSED REVISION OF CAPITAL GAINS TAXATION

Here, again, we want enthusiastically to endorse and aline ourselves with the following observations in the introductory paragraph to this part of the President's tax message to the Congress:

"The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth. * * * The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives."

These observations and goals reflect the subtance of the position which representatives of our association have taken before your committee and elsewhere for many, many years.

H.R. 8363 would—

(1) Reduce the percentage inclusion on gains realized after 2 years from 50 to 40 percent, with a maximum rate of 21 percent.

(2) Permit indefinite carryover of unused capital losses.

(3) Define capital assets eligible for the lower percentage inclusion rate to include securities and real estate.

As the committee knows, our position for a long time has been that halfing of the present capital gains tax rate and holding period would not only make a greater contribution to the economic goals to which the bill is addressed, but that it would also substantially increase Federal revenues by freeing vast amounts of capital which is presently "locked in" by the tax. However, the proposed capital gains tax reforms contained in the bill are, again, certainly steps in the right direction. We endorse them and urge their enactment.

THE PROPOSED REPEAL OF THE 4-PERCENT DIVIDEND TAX CREDIT AND THE INCREASE OF THE PRESENT $50 DIVIDEND EXCLUSION TO $100

These proposals, as well as the taxation of capital gains discussed above, involve two areas of our tax law with which our industry has to deal every day and, indeed, almost every minute of every day. We thus have a special concern about these proposals and we believe our industry is perhaps especially qualified to comment on their implications, not only for the securities business but also for investors, corporations, our economy generally, and the goals to which the bill is addressed.

We endorse, as we have in the past, increasing the dividend exclusion from $50 to $100.

We are very strongly opposed, however, to the proposed repeal of the 4-percent dividend received credit.

Your committee has already received voluminous testimony in opposition to the repeal of the 4-percent dividend received credit, as did the Ways and Means Committee at its hearings earlier this year. In general, we concur with the views so expressed. Mr. G. Keith Funston, president of the New York Stock Exchange, submitted an admirable statement to your committee on October 25, 1963, dealing comprehensively with this subject and testified ably thereafter in response to questions from the committee. Mr. Funston's statement and testimony is contained in part 2 of the printed hearings before your committee beginning at page 911. We thoroughly subscribe to the points and arguments made in both his statements and testimony and so we shall not repeat those arguments here in detail.

By way of summary, however, with respect to the repeal of the 4-percent dividend credit, we take the position that—

(1) We do have in this country double taxation of corporate dividends. Such treatment is not inflicted on wages, interest, rents, or other forms of income;

(2) The dividend exclusion and tax credit enacted into law in 1954 were only intended as a partial first step toward relief from double taxation;

(3) The relief provided by the dividend credit in relative terms is the same for everyone—up to 4 percent of taxable dividends;

(4) The 4-percent credit gives a bigger percentage reduction to the lower income brackets—a 20-percent reduction to someone in the 20-percent bracket but only 4.4 percent to someone in the 91-percent bracket.

(5) The dividend exclusion and tax credit have had a positive effect in encouraging equity investment;

(6) The effect on equity investment of the dividend exclusion and tax credit has necessarily been modest because the relief enacted was modest. The answer is, therefore, not to repeal these provisions but, rather, to increase them;

(7) When the credit-exclusion were enacted in mid-1954, the Nation's shareholders numbered fewer than 7½ million. A year ago the total exceeded 17 million and, by all indications, is still rising.

(8) The credit-exclusion are not necessarily ideal forms of relief from double taxation of dividends but Congress in 1954, after much study, concluded that this was the most practical approach toward partially correcting the wrong which came into our tax laws back in 1936; and

(9) Until some better approach is found, the credit-exclusion should be retained and, preferably, expanded.

INCOME AVERAGING

The bill, in effect, provides for the averaging of income over a 5-year period where the income in the current year exceeds the average of the 4 prior years by more than one-third and this excess equals at least $3,000.

We heartily endorse this concept in the interest of greater equity for all taxpayers involved. Over the years it would provide much fairer tax treatment for many taxpayers, including firms in the securities business whose income fluctuates widely.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

By way of summary, we respectfully request the committee's consideration of the following:

THE RATE REDUCTIONS—BOTH CORPORATE AND INDIVIDUAL

1. We strongly recommend that the tax rate reductions, both corporate and individual, proposed by this bill, or any modification thereof deemed appropriate by your committee, be made effective as of January 1, 1964.

2. We enthusiastically subscribe to the proposed declaration by Congress in section 1 of the bill.

3. We approve the proposed tax rate reduction for corporations and recommend its adoption.

4. We believe that a rate reduction formula which would, over a given period, bring the top individual rates below 50 percent, and which has greater thrust in the tax brackets where initiative, incentive, savings, and investment can most directly be stimulated, would better achieve the overall objective of the bill than the tax rate structure contained therein. We, nevertheless, approve the individual tax rate structure proposed in H.R. 8363 as a step in the right direction and urge its adoption.

PROPOSED REVISION OF CAPITAL GAINS TAXATION

We heartily endorse President Kennedy's views as to the general need for revision in this area. We believe that halving of the present capital gains tax rate and the holding period would not only make a greater contribution to the economic goals to which the bill is addressed but that it would also substantially increase Federal revenues. However, the proposed capital gains tax provisions contained in the bill are, again, steps in the right direction. We endorse them and urge their enactment.

PROPOSED REPEAL OF THE 4-PERCENT DIVIDEND TAX CREDIT AND INCREASE OF THE PRESENT $50 DIVIDEND EXCLUSION TO $100

We endorse increasing the dividend exclusion from $50 to $100. We are strongly opposed to the proposed repeal of the 4-percent dividend received credit.

INCOME AVERAGING

We heartily endorse this concept in the interest of greater equity for all taxpayers involved.

STATEMENT OF STEPHEN D'ARRIGO, SALINAS, CALIF., ON BEHALF OF D'ARRIGO BROS. CO. OF CALIFORNIA AND CALIFORNIA GRAPE & TREE FRUIT LEAGUE

The tax problems of agriculture and in particular the fresh fruit and vegetable industry are no different than those confronting the manufacturing, retail, or service industries. We need an increasing amount of capital so that we can keep abreast of advancing technology, maintain an adequate employment level, and make the maximum contribution to what we hope will be a rapidly expanding economy in the decades ahead.

We are convinced that the new tax rate structure, individual and corporate, in H.R. 8363 will not permit the various segments of our economy to make this maximum contribution. We, therefore, respectfully urge you to consider major changes in the H.R. 8363 income tax schedules before sending a bill to the Senate. We also urge you to do the utmost to halt the persistent upward trend in Federal spending if the benefits of any tax reduction are to be fully realized.

The individual rate structure in the bill before you, so heavily weighted in the direction of boosting consumer purchasing power, coupled with constantly mounting Federal spending, might well unleash a new round of inflation. The Nation's agricultural producers, like all other segments of the economy, have suffered too long from deficit-inspired inflation.

One might ask why the American farmers should need more capital in view of record high surpluses of some agricultural commodities. While the surplus problem does not afflict the fresh fruit and vegetable industry, we are nonetheless convinced that the need for capital applies equally to all segments of agriculture. We must assure that agricultural production is adequate to meet the expanded needs that will result from the coming population explosion. For example, recent figures indicate a population increase of 30 million by 1970 and 50 million by 1975. Agriculture must be able to meet the demands of these additional people for the huge quantities of food and fiber that will be required. We must meet these demands with a steadily declining farm population. The number of farms declined over 30 percent in the decade of the 1950's. Recent predictions indicate a further drop of more than a million farmers in the next decade.

These general trends clearly emphasize a twofold need for more capital:

1. To enable the remaining farmers to produce on a basis which is more efficient technologically in order to meet the market demands of the existing urban population as well as those who are added to this population due to the shift of former farm employees and farmers to urbanized areas.

2. To provide the additional jobs for former farm employees who must turn to nonagricultural employment as a means of livelihood.

From the many debates on farm legislation in recent years, members of this committee are familiar with the problems facing American agriculture, including the fact that food prices paid to the farmer have been declining steadily, production expenses have risen steadily, realized net farm income has declined steadily and farm profit margins per unit of output have been shrinking rapidly.

Because of these declining prices and rising costs, farm profitability and farm income can be raised in a number of ways: (1) By the injection of more Federal funds; that is, further subsidization. This is a course of action which we hope the Congress would emphatically reject. (2) By expanding the volume of sales. This can be accomplished if we put an end to chronic unemployment and our economy moves ahead to the heights of which it is capable. Under these conditions, the American farmer can provide more and better food at what we hope will be a price that all can afford. (3) By leaving in the farmer's hands, whether individual or corporate, more income after taxes.

To those who believe in the free competitive enterprise system, the second and third approaches are obviously the only road this Nation should take. These approaches can best be furthered by a more moderate tax rate structure than is included in H.R. 8363. Our branch of agriculture includes small individual farm proprietors, with as little as 20 acres, as well as the larger corporate farmer. Therefore, our recommendations regarding tax rates cover both individual and corporate.

H.R. 8363 does not adequately reform what is generally conceded to be an outmoded and repressive individual rate structure born during years of depression and war. Instead, it concentrates the greatest percentage rate reductions in the very lowest and the very highest brackets with minimum reductions in the steeply graduated middle income brackets. If the individual farmer is successful despite the handicaps noted earlier, he is faced with the full fury of these steeply graduated rates and is thereby unable to make his full contribution to a growing economy and further unable to adequately provide for his future and that of his family.

The key to a fully reformed individual tax rate structure lies in a minimum of percentage points between rate brackets as one moves up the income ladder. We have long supported the Herlong-Baker legislation because this is exactly what it would provide; a 1 percentage point jump between existing brackets. We are aware this committee is not considering a tax reduction bill as broad in scope as the Herlong-Baker legislation. Within the limits of H.R. 8363, however, we strongly urge that you revise the individual rate structure so as to establish a minimum of percentage points between brackets, at least through the lower half of the graduated scale; that is, up to the $22,000 bracket. There is no economic or scientific reason for a new rate structure, dedicated to economic progress, to jump by 3 or 4 percentage points between the smallest graduated brackets, $2,000 each, in the lower half of the scale. The rate schedule in H.R. 8363 perpetuates just such a pattern and in fact, viewed as a whole, actually increases an already too steep curve of graduation.

Unless any tax reduction enacted by this Congress recognizes the need for greater relief in the middle income brackets, we will not be realizing the Nation's full potential for savings which in our economic past have always been an important source of venture capital.

In recent years it has been generally believed the only source of capital available to the individual entrepreneur and to the small and moderate size corporation is either retained earnings or bank borrowing. To a substantial and perhaps unfortunate extent, this is an accurate picture. However, we all must look back with some nostalgia to the years gone by when an important source of venture capital, perhaps the most venturesome, was the savings of the successful person, who found pride and satisfaction, and could take the risk in the hope of profits, from giving a financial lift to a new enterprise. This source has been fairly well depleted by the extremes of rate graduation, both as regards to the capacity to save and the incentive to use such savings if and when they are accumulated. Instead, we find that the successful person who does accumulate from savings is more interested in safe and tax-sheltered investments rather than risky enterprises which, even if successful, will provide only a minimum after tax return.

If a more moderate tax rate structure, particularly in the middle-income brackets, will once again open up this source of venture capital, then the approval of such a structure would be the single most important contribution this committee could make to the long-range economic health of our Nation.

The corporate rate reductions in H.R. 8363 are similarly deficient in relation to their contribution to capital formation. A total reduction of $2.2 billion in corporate tax liabilities will be welcomed by the Nation's corporations, but we should consider most carefully the method used to achieve this reduction, as well as its magnitude.

Since the new and lower corporate tax rate would be only 48 percent, we must be mindful of the fact that the Nation's corporations have long believed that there exists a sort of promissory note, renewed annually by the Congress, under which the top corporate rate would be permitted to drop to 47 percent on some June 30. The top corporate rate, effective during the period between the end of World War II and the Korean war was only 38 percent.

Further, the corporate reduction in H.R. 8363 would be achieved within the framework of a reversal of the corporate normal and surtax rates. The present normal tax on the first $25,000 of income is 30 percent and the surtax on income above $25,000 is 22 percent. H.R. 8363 would impose the 22-percent surtax rate on the first $25,000 of income and would ultimately reduce the new 30-percent surtax rate to 26 percent, leaving a new combined top rate of 48 percent. The new surtax rate would be 4 percentage points higher than under present law. By contrast, if the Congress had redeemed the promissory note referred to above, the corporate normal rate would drop to 25 percent and the surtax rate would remain at 22 percent.

H.R. 8363 would provide a rate reduction of about 27 percent on the first $25,000 of corporate income, but on income above $25,000 a reduction of less than 8 percent.

The primary tax problem of growing small corporations has not been the normal tax of 30 percent but the surtax of 22 percent. In fact, the greatest problem of the incorporated small business comes when it has to get by the hurdle of the 22-percent surtax rate. H.R. 8363 would raise this hurdle to 26 percent. Many small businesses have surmounted the existing hurdle by multiplying their corporate units. H.R. 8363 not only raises the hurdle to 26 percent, but imposes new hurdles by limiting the possibility of setting up multiple corporate units since it would impose a 6-percent penalty tax if this course of action is followed.

Growing companies faced with a tax hurdle of 26 percent rather than 22 percent would be facing the same sort of discouragement applying to unincorporated businesses, both in present law and under H.R. 8363, except that the individual tax hurdles are more numerous and much steeper. For example, a married couple owning a business or a farm in 1965, would still pay a top marginal rate of 36 percent on taxable income up to $25,000 as compared with the 22 percent rate applying to a similar business which is incorporated.

It borders on an affront to successful small corporations to offer them a tax bone, in the form of a 22 percent normal rate, and then set an effective limit, the 26 percent surtax rate, on their efforts to grow and expand. The end result might be a further spreading of discontent with the tax law.

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The issue of reversing the corporate normal and surtax rates is not a new one. It has been before this committee and the Senate on a number of occasions. The issue in the past was a simple reversal without a reduction in either rate. The hearings before this committee and the Senate debate indicate there was fear of the discontent referred to earlier and, further, that this discontent with a higher surtax rate might result in eventual pressure for a fully graduated corporate tax. In discussing this amendment in 1957, the late Senator Robert S. Kerr said: "There, Mr. President, is the secret to the effort behind the amendment; namely, to bring about a graduated formula for the taxation of corporations—a formula which, instead of being an aid to the small businessmen, would be the death knell to the growth of small business, and would be detrimental to the millions of small people who own stock in corporate entities."

If this possibility still exists and we believe it does, we respectfully urge this committee to weigh very carefully whether corporate rate reduction should be enacted within the framework of reversing the normal and surtax rates.

The Nation's agricultural industry, individual farmers and corporations, need major tax reduction. They need tax reduction of a type that will assure the capital necessary to meet the needs of our growing population. The rate schedules in H.R. 8363 provide no assurance they will permit the accumulation of this capital because of their discrimination against middle income taxpayers and the failure to provide adequate corporate reduction.

The rate reductions in H.R. 8363 are weighted heavily in the direction of increased consumer purchasing power. Certainly, we in the fresh fruit and vegetable industry need increased consumer purchasing power and we favor a balanced tax reduction. But we urge that before tax reduction is enacted the balance be altered to provide more incentive for investment. Figures have been presented to this committee which indicate that of the $11 billion total tax reduction, $8 billion would go to increased purchasing power and only $3 billion to investment. This is the balance that must be shifted away from simple short-range stimulation and toward long-range economic growth. This story was perhaps best told in a recent report by the committee on Federal tax policy of the Tax Foundation which said:

"Since the object of economic activity is the production of goods for consumption, the fundamental problem is to find the tax policy which would be most effective in helping everyone to a higher level of income. A stimulus to consumption can help raise gross national product only in the short run. For the longer run, growth of consumption depends on expansion of productive capacity.

"We by no means hold to the view that 'growth at any price' should be the American goal. We do believe that Americans should recognize that, for the longer run, 'consumption-oriented' and 'investment-oriented' tax reductions are rivals. A rising level of consumption cannot be maintained if new investment is made simply in response to the pressure of current consumption. Our tax system should not impede a continuing high level of autonomous investment incorporating new technology and creating new patterns and forms of consumption."

Finally, it is our belief that if tax reduction of any sort is to have its intended beneficial economic effect it must be accompanied by concurrent reduction and control of Federal expenditures, including those for agriculture.

We are in agreement with the chairman of this committee and other Members of the Senate who have suggested that no great harm will be done if tax reduction legislation is delayed until the 1965 budget is presented next January, particularly since there should be no great difficulty in enacting tax reduction retroactive to January 1, 1964. If, in addition to taking a long, hard look at Federal spending, this committee uses the time between now and completion of its examination of the 1965 budget to rewrite the rate schedule along the lines we have recommended, the Nation would benefit more than it would from too hasty enactment of H.R. 8363, as now written.

MEMORANDUM CONCERNING THE INTEREST EQUALIZATION TAX SUBMITTED BY JOHN W. HANES, JR., WERTHEIM & CO., NEW YORK, N.Y.

The interest equalization tax is designed to curb the outflow of portfolio capital, which showed an accelerating trend in the first half of 1963. We believe that such a tax, if it is enacted all, should be confined to new issues of debt securities. Outstanding securities, both debt and equity, should be excluded, as should new equity issues.

For the sake of clarity, we shall classify the securities subject to the proposed tax as follows:

1. New issues of debt securities.
2. Outstanding debt securities.
3. New issues of equities.
4. Outstanding equities.

The balance-of-payments problem which this bill is designed to deal with concerns only the first category; namely, new issues of debt securities. This fact is admitted by the administration.

In Secretary Dillon's own words "clearly, the major problem at the moment, in terms of sheer dollar volume, relates to new debt issues. These accounted for more than four-fifths of the outflow from all portfolio transactions in foreign securities over the first half of this year, and for the bulk of the increase over the past 12 months."

The following figures will put the problem in perspective:

TABLE I.—*Analysis of foreign security transactions (minus represents net outflow)*

[Millions of dollars]

	1st half 1963	1962	1961	1960
New issues (less redemptions):				
(1) Debt	−880	−832	−364	−439
(2) Equity	−32	−74	−36	−14
Outstanding securities:				
(3) Debt	−104	−29	−27	−102
(4) Equity	−2	−26	−326	−75
Total	−1,026	−961	−753	−650
Column (1) as a percent of total	86	87	48	71

Source: Hearings before Committee on Ways and Means on H.R. 8000, pp. 85, 86.

It can be seen that in the first half of 1963 the outflow of long-term portfolio capital was running at more than double the already inflated rate of 1963 and the increase was due almost entirely to new issues of debt securities.

As a matter of fact, the importance of outstanding securities from the point of view of H.R. 8000 is even less than the above table indicates. The proposed tax does not apply to outstanding securities of undeveloped countries and international institutions. If these securities are excluded, transactions in outstanding securities resulted in a net inflow in 1962 and only a very modest outflow in the first half of 1963. The following table, which combines outstanding debt and equity transactions, clearly shows this fact.

TABLE II.—*Transactions in outstanding securities (minus represents net outflow)*

[Millions of dollars]

	1st half 1963 [1]	1962	1961	1960
Total, (sum of cols. 3 and 4 in table I)	−100	−55	−353	−177
Europe, Canada, and Japan	−22	+55	−317	−123
Others including international institutions	−78	−110	−36	−54

[1] The 1963 1st half total does not correspond precisely with table I, presumably because these are preliminary figures. The difference is insignificant.

Source: Survey on Current Business, September 1963, p. 14.

The balance-of-payments problem in this area which has arisen in the first half of 1963 is confined, therefore, to a sharp increase in new issues of debt securities. The influence of the other three categories has been negligible. The only reason advanced by the administration for including them in the proposed tax is that their importance may possibly increase in the future if a tax is imposed on new issues of debt securities. We shall deal with each category separately.

OUTSTANDING DEBT SECURITIES

Secretary Dillon has argued before the House Ways and Means Committee that "the interest of American investors in outstanding foreign debt issues could be expected to rise very substantially if such issues remained freely available without tax, while the volume of new issues reaching our market contracted." We believe this statement is difficult to sustain.

The volume of foreign dollar bonds currently outstanding is limited and can be increased only by means of new issues. It is true that substantial amounts of foreign dollar bonds are currently held by foreign investors; but there is no good reason to expect that these foreign owners would become more anxious to sell such holdings than they have been in the past, unless American investors were willing to pay them a substantial premium to do so. But for an American investor to do so would diminish, and probably eliminate the interest advantage which would have attracted him to a foreign debt issue in the first place. The fact that no premium has developed on outstanding foreign debt issues since the introduction of the proposed tax measure supports this argument.

It has been argued that a tax on new debt issues could be frustrated by issuing them abroad and then selling them relatively soon in the United States as outstanding issues. Such a possibility can easily be removed by imposing a limitation on the date of issue of bonds exempt from the tax.

It has also been suggested that there might develop a procedure whereby a foreign issuer would buy up outstanding dollar bonds and sell them to Americans, replacing them to the foreign holder with a new issue. In other words, when a new issue came along, the seller of the new issue abroad would merely go to his clients and say, "Here, take this new issue, and I will take in payment your old issue, and then I will go sell that in the United States."

Now it should be recognized that trading in outstanding bonds moves through quite different channels than the placing of new issues. The bulk of new issues in the first half of 1963 consisted of private placements; these require a higher interest rate than marketable securities of a comparable grade. Therefore, it would be impracticable to use the private placement technique for already outstanding bonds. Moreover, seasoned bonds command a higher price than new issues and are rarely available in large blocks. The difference in interest levels would have to be very substantial, probably more than 1 percentage point, to make the transaction suggested above feasible.

To take a practical example: The city of Copenhagen has recently issued $14 million worth of 5-percent bonds in London at a price to yield 5¼ percent. There is a city of Copenhagen issue already outstanding with a 5⅝ percent interest rate selling at par with affidavit of American ownership attached. A foreign holder would have no advantage in selling his bonds to an American investor if the security he could replace it with yields less—nor is he likely to go through the disruption of replacing it even if the new issue were at a slightly higher rate than his present holding.

NEW ISSUES OF EQUITIES

With regard to new issues of equities, Secretary Dillon stated before the House Ways and Means Committee that "the issuance of equities is an alternative to debt financing in raising capital, and the choice is directly influenced by relative cost. Similarly, for many investors, bonds and stocks represent alternative uses of funds. Both debt and equity capital are relatively cheap in the United States today, and in these circumstances it would clearly be inconsistent to tax foreign access to one market and not to the other."

We believe that the following facts diminish the force of this argument:

(i) A major part of foreign debt issues are floated by governments and other public or quasi-public entities which have no common stock available to the public.

(ii) As far as corporate bonds are concerned, more than half of them are placed privately, and many of the financial institutions involved are prevented by their statutes from taking common stocks instead of debt securities.

(*iii*) The public sale of equities is governed by the Securities and Exchange Commission and foreign corporations often have difficulties in meeting SEC reporting and other requirements. This has been a major inhibiting factor to the underwriting of foreign equities in the past and can be expected to remain so in the future. For instance, when International Telephone & Telegraph Corp. wanted to sell its holding of L. M. Ericsson Telephone Co., it had to do so abroad because the shares could not be registered under SEC rules.

The Investment Dealers' Digest published the following statistics concerning new issues of foreign securities sold to the public by U.S. underwriters, as distinct from private placements.

TABLE III.—*Underwriting by type of issues*

[Millions of dollars]

	1st half, 1963	1962	1961	1960
Foreign government bonds	$172.5	$217.5	$148.0	$214.3
Foreign corporate				
Bonds and preferred stocks	25.3	120.5	29.5	45.0
Common stocks	35.4	20.6	9.5	

Even if corporate bond issues were replaced by equity issues whenever possible, the amounts would remain insignificant. In the first half of 1963, for instance, the increase in equity issues would have amounted to only $10 million, because the remaining $15 million of corporate bonds was represented by an issue of the Copenhagen Telephone Co. which has no private stockholders.

Furthermore, if it is deemed desirable to discourage or restrict new issues of equities, other less drastic means to accomplish this should be available such as by tightening existing SEC procedures.

OUTSTANDING EQUITIES

None of the foregoing arguments apply to trading in outstanding foreign equities. Even Secretary Dillon was only able to say before the House Ways and Means Committee that: "American investment advisers and investing institutions, including pension funds, with increasing frequency seem to believe that diversification could be improved by investing a portion of their assets in foreign equities. When one considers the billions of dollars currently invested in stocks by pension funds alone, it is easy to realize that an attempt to place only 5 percent of these assets in foreign securities—as some have recently begun to do—could lead to an outflow of many hundreds of millions of dollars per year, far outpacing our efforts to induce more purchases of American securities by foreigners. Regardless of the merits of such diversification in the long run, there is no question but that a cascading of such purchases in present circumstances would gravely strain our overall balance-of-payments position."

There is no factual evidence to indicate that any such "cascading" has been in the process of developing. On the contrary, transactions in outstanding securities of the countries which would be subject to the proposed tax resulted in a net inflow of dollars in 1962 and a smaller than average outflow in the first half of 1963. Incidentally, it is misleading to utilize figures concerning gross purchases because they include only one side of an investment switch or arbitrage operation, and there may be a corresponding sale. The only thing that matters for the balance of payments is net purchases.

There is no reason to believe that the imposition of a tax on new foreign debt issues would lead to an increase in purchases of outstanding foreign equities. Such purchases are governed by the attractiveness of foreign business enterprises and markets relative to our own. Insofar as the proposed tax would have any effect at all, it would be to make foreign equities less attractive by making it more difficult for foreign companies to meet their financing requirements by debt issues.

There is a suggestion in the administration's argument that the imposition of a tax on new issues would make American investors more anxious to send their funds abroad by purchasing outstanding foreign equities. Although this argument is not stated explicitly, we should like to deal with it here so as to avoid any possible confusion.

The proposed tax would in no way hinder the transfer of capital abroad (*a*) for safekeeping in a foreign currency; (*b*) for lending to foreign borrowers provided the loan has a maturity of less than 3 years, or (*c*) for the purchase of any property other than securities. There is no logical connection between the transfer of funds abroad and the buying of foreign equities. On the contrary, the purchase of equities requires a forward-looking optimistic attitude which is the exact opposite of the attitude motivating flight capital.

To sum up: While there is some relationship between new debt issues on the one hand and outstanding debt issues or new equity issues on the other, the relationship between new debt issues and outstanding equities is so tenuous and indirect that it can be safely regarded as nonexistent.

As regards outstanding debt issues and new issues of equities, it has been shown that there are strong technical reasons why it is unlikely that private investment abroad should shift to these categories if a tax is imposed on new issues of debt securities. The extension of the tax to the three other categories would make no significant contribution to the solution of our balance-of-payments problem. On the contrary, it may have farflung adverse repercussions by interfering with the free market mechanism over a much broader field than is necessary.

The adverse effects could be mitigated by allowing American investors to switch from one foreign investment to another. There are, however, two main arguments against switching. One is that it would allow a dual exchange system to develop. We consider this possibility rather remote, because in the present environment American investors would remain net sellers on balance. The other objection is that switching would be difficult to administer. This objection is valid, but it also applies to the proposed tax as it stands. It would be much simpler to exclude outstanding securities altogether.

BUSINESS AND PROFESSIONAL WOMEN'S
CLUBS OF NEW YORK STATE, INC.,
Rensselaer, N.Y., November 26, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The Business and Professional Women's Clubs of New York State heartily endorse Senator Neuberger's proposed amendment to H.R. 8363, now before the Finance Committee, an act to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes, to make certain structural changes with respect to the income tax, and for other purposes.

The legislative platform of our national federation, adopted at the annual convention last July 14–18, provides for active support of equitable tax adjustments including "allowance of an income tax deduction to an employed person, regardless of income, for costs of the care of dependents because of said employment."

We feel that the increase under the proposed amendment in the amount of deduction allowed and in the amount of limitation on income to be eligible is most desirable in view of the rise in wages and living costs and in view of the fact that so many women must work to supplement their husbands' income in order to maintain a decent living standard for their families.

Sincerely yours,

HULDAH C. SEGAL,
Legislation Chairman.

U.S. SENATE,
November 18, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Quoted below are excerpts from a letter I received from Mr. Don Evans of Burlington, Vt., concerning a flexible exemption for income tax purposes:

"The first step in this direction would be to establish a realistic figure for exemptions. Social security has been explained to me not as an income adequate for living but rather an economic status below which no American should be subjected to, by representative of the Social Security division of United States.

Average individual payments would run somewhere in the neighborhood of $1,000 annually. Isn't it ridiculous then for tax purposes to establish a $600 individual tax exemption. If a figure more in line with the cost of living were established—say $1,200—and this figure subjected to a sliding scale based on cost of living figures issued by U.S. Department of Labor Statistics—as many union management labor contacts for the purpose of establishing salaries and wages—a more workable system could be devised which would not unduly penalize those in the higher brackets and would allow those in the lower brackets to increase their purchase of necessities and possibly a few luxuries. This increase of purchasing power where it would be sure to be utilized could well solve many of the problems of unemployment, surpluses, and the additional Government expense of solving these problems. It would allow a more general spread of the benefits of the $50 exemption on dividends and the 4-percent credit on dividends without unduly penalizing those on fixed incomes from such sources. It would eliminate tax allowance for students and parents for education paid for by them and allow them to do it for themself without Government support. It is always cheaper to allow people to keep their money to use than to collect it from them in taxes and then subsidize their expenses from those collections."

Sincerely yours,

WINSTON L. PROUTY.

U.S. SENATE,
November 26, 1963.

HON. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: Following are excerpts from a letter which I received from Mrs. A. Neil Finlayson, of Durham, N.H., concerning income taxes.

"A working mother may deduct from her income tax the full cost of household help. But . . . (*a*) when she returns to graduate school to earn a Ph. D., and is earning no wage, she cannot deduct the cost of household help from the joint return.

"This is hardly encouraging. I feel there would be many more women return to academic work if the cost of help could be deducted from the family income while they are in graduate school.

"In my case, while I worked full time teaching, my housekeeper's fee was deductible. Now I am using family money instead of adding to it—in order to complete my doctorate degree and we can no longer deduct the $30-week cost of help.

"You are making a good start by asking for the tax relief for students working to put themselves through college. While there are not many working mothers who return to college at present, similar tax consideration would certainly encourage many more.

"In the United States, women with a B.S. degree in sciences and other disciplines represent a vast reservoir of already partly educated and partly experienced professional workers. As mothers of small children, they are making a purely domestic contribution. But when these children are grown, many such women would enjoy the challenge of finishing their educations and filling a professional niche.

"We could shortcut much of the difficulty in trying to produce our needed 7,000 Ph. D.'s a year (presently, we are producing 3,500), if we looked to women in this reservoir I speak of.

"As an example, I will use myself. In 1949 I was a B.S. graduate and taught school science classes. Later I had two children (both born in Springfield, Vt.) and in 1959 returned to teaching. In 1962 I came to graduate school and expect to have a doctorate in ecology by late 1965. I will then teach on the college level and engage in ecological research. This work meshes well with my family responsibilities. You can see that graduate work benefits both my own future and my community's."

Sincerely yours,

WINSTON L. PROUTY,
U.S. Senator.

STATEMENT OF HERMAN KENIN, PRESIDENT OF THE AMERICAN FEDERATION OF MUSICIANS, AFL-CIO

Thank you, Mr. Chairman and members of the committee, for this opportunity to present the views of more than a quarter of a million professional musicians with respect to H.R. 8363 (the tax reduction bill) and particularly as to S. 2068, proposing amendments thereto, with respect to existing travel and entertainment expenses.

The Federation of Musicians has previously testified, registering its approval in the records of this Congress, of the broad and salutory provisions of the tax reduction bill. We musicians, like our brethren of the AFL-CIO, believe it holds much promise of relieving the widespread unemployment that afflicts our national economy.

Even more directly and immediately important to the work opportunities of literally hundreds of thousands of employees in the vast entertainment industry is the need to include in the current omnibus tax bill the wise reforms proposed in S. 2063 by Senator Long, and cosponsored by 19 of your colleagues, including 4 other Finance Committee men; namely, Senators Carlson, Curtis, McCarthy, and Ribicoff.

The wise provisions of S. 2068, while designed to ease the harmful impact of the entertainment an travel expense provisions of the 1962 tax legislation, retains intact the broad intent of the Congress under section 274 (designed to eliminate abuses), but grants a flexibility that recognizes legitimate and traditional business practices. In short, Senator Long and his associates have proposed a practical solution to the repressive, job-destroying regulations growing out of the language of the 1962 act.

The inordinate deprivation of work opportunities for musician sand thousands of others resulting from the Internal Revenue Service's multiple and still confusing interpretations is illustrated by an inflexible regulation that holds:

"If an establishment is quiet enough to permit businessmen to discuss business it is not necessary to discuss business in order to sustain an entertainment tax deduction. Conversely, if the establishment provides music or other entertainment there can be no entertainment expenses deduction unless the business discussion directly precedes or follows immediately the courtesies of entertainment."

Thus, our musicians who depend so largely upon what was once a vast and legitimate business entertainment patronage to support employer payroll capability are being laid off so that establishments where they used to work will be "conducive to the discussion of business."

What this kind of official interpretation has done and will continue to do to the already undernourished cultural entities of the performing arts in opera, theater, symphonic performances, and most other aspects of the entertainment business is obvious and needs no elaboration by me.

Surely, Mr. Chairman and members of the committee, you will recognize the need to correct a travesty in our always complex tax system that poses these obstacles:

(1) A year after enactment of the enforcing rules it has been necessary to install a special training program for IRS's 14,000 revenue agents in order to explain to these experts what the 1962 law means.

(2) The Internal Revenue Service has never before found it necessary to publish voluminous and long-delayed questions and answers to provisions of the Tax Code. This is found necessary only in the entertainment and travel area.

(3) The admittedly complex tax laws have reached the frustration point for all taxpayers when they demonstrably defy interpretations for such a routine act as entertaining a customer or prospective customer in the traditional American manner of doing business.

I shall not add further to this record, recognizing that time is of the essence in bringing tax relief to all Americans. I only plead that in your considerations, Mr. Chairman, that you and your committee and your conferees in the House of Representatives will consider, understandingly, the plight of the musicians and our brethren in the performing arts who will be sorely harmed unless the provisions of S. 2068 are incorporated in the legislation we trust you will soon recommend to the Congress.

Thank you for your invitation to present the views and pressing needs of our musicians.

STATEMENT OF THE VIRGINIA MANUFACTURERS ASSOCIATION ON H.R. 8363

(Submitted by Charles H. Taylor, Richmond, Va.)

Mr. Chairman and members of the Senate Finance Committee, our concern is for the kind of tax reduction which can accomplish the stated objectives of the measure now before you; that is, to expand our privately financed base productive economy.

We feel that the urgency for a prompt reduction in corporation income tax rates is such that we should confine our presentation primarily to this.

As passed by the House, this measure gives major emphasis to consumption rather than to investment incentives, which we all acknowledge have been too long neglected to the detriment of our citizen-owned productive complex. If this country believes in an economic system which relies upon the expansion of private investment, now is the time to make it known through actions which are clear and positive.

Our ability to make large reductions in the lowest income brackets, while, at the same time, increasing employment security benefits and Government programs and services largely for this group, is highly questionable. It is even more questionable to assume that this can be done, and at the same time, reduce the level of taxes on corporations and individuals in higher brackets to whom we must look for the necessary additional investment in private enterprise.

The acid test for long-term investment is paid dividends to investors. Investments for speculative growth potential or hedge against inflation are slender reeds upon which to rely for an indefinite period of time. This has been the case for too long and at considerable risk, we would observe.

By any measure, corporate profits after taxes are inadequate whether measured as a percentage of invested capital or of sales. This situation has already existed too long and must have immediate attention if we are to realize the needed investment to meet our expansion goals.

Equally disturbing has been the necessary growth of private corporate debt, as well as that of local government, in their attempt to meet the needs of expansion of private enterprise and the increased needs for local government services. High-level Federal officials have applauded the slow rate of growth of Federal debt as compared with the steeply rising debt of private corporations and local government. In reality, this is poor consolation. It should be said that the high level of Federal taxation has failed to satisfy the appetite of Federal spending while, at the same time, causing private enterprise and local government to have to resort to fast and steady increases in their debt structure in striving to cope with their needs. This is clear evidence of the imbalance in the distribution of our earnings and its impediment to the growth of our base productve economy. A reduction in the Federal tax structure would release resources to our private base productive economy which, through expansion, would multiply the returns to every level of government over and above its accomplishments for individuals. In the continued use of an excessively high level of corporate income tax over a long period of years, the Federal Government has eaten into the equity of our privately financed productive economy. It is nothing short of madness to continue to dissipate the equity of American enterprise.

This committee has been provided many charts and comparisons focusing on the problem. We will not burden you with a repetition of numbers with which you are all well familiar.

Our plea is for an immediate tax reduction for corporations in the amount of 5 percent, which would restore the rate to the pre-Korean war level. This would provide immediate stimulus for investment and would renew the confidence of invesors more than anything which has been proposed. It would enable most corporations to increase dividend payments—most of which are long overdue. To hedge or to delay such action will only impede the incentive to invest, which is the announced purpose of taxation reduction at this time.

We would prefer prompt tax reduction to this extent over enlargement of the investment tax credit. As stated before when the investment tax credit was being debated, we recognize this as highly inequitable tax treatment as between the various corporations, and as an undesirable manipulative tool of Government. While a certain few business ventures stand to benefit substantially, the

vast majority would not derive equitable benefit from it. We would, therefore, urge a prompt, across-the-board decrease in the corporate income tax of 5 percent with no expansion in the investment tax credit. Consideration of investment tax credit could be eliminated by outright repeal of that section.

The dividend credit is an essential means of providing relief from the double tax on corporate earnings and dividends which increases sources of equity capital. It is most important to the small investor. It is inconsistent with the objective of the present tax legislation to consider its elimination.

We are for a meaningful tax reduction which will not be dissipated through inflation. It cannot be achieved merely through borrowed money. This calls for a concurrent, determined effort on the part of the Federal Government to live within its anticipated current income. Curtailment and control of Federal spending is essential to achieve this end. Unnecessary Federal spending proposals must be rejected and projects which have outlived their useful life must be abandoned forthrightly. The 1964 Federal budget must be made to reflect this—action must match promises to merit any confidence. This must be done if we are to begin building a solid foundation for our future growth needs in the private sector of our economy.

THE VOICE OF THE PEOPLE IN ACTION
(THE SOCIETY OF THE PEOPLE, INC.),
Chillum, Md., December 3, 1963.

Senator HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR: In reply to your letter of November 14, I can only say that we were very disappointed in being notified that we cannot appear as a witness on H.R. 8363 as was scheduled for Friday, December 13.

Under the circumstances we are happy, of course, to submit the enclosed written statement of our views in lieu of appearing and we appreciate that the statement will be incorporated in the printed record of the hearing.

We appreciate the assurance that our written statement will be analyzed by the staff and the recommendations contained therein called to the attention of the members of the committee.

Sincerely,

DR. RUSSELL FORREST EGNER, *President.*

STATEMENT OF DR. RUSSELL FORREST EGNER, PRESIDENT, THE VOICE OF THE PEOPLE IN ACTION (THE SOCIETY OF THE PEOPLE, INC.)

Honorable Chairman and members of the committee, I am privileged to have the opportunity of submitting a statement for the consideration of this committee and the Congress concerning a reduction in taxes. Our members are voicing a request for tax reduction, with special emphasis for relief in the lower and middle brackets and the small businessmen. We likewise advocate a curtailment of unnecessary and wasteful spending.

Our research and actual contact with people and small businessmen discloses that there is a lack of consumer spending money and it is costing too much to do business in proportion to the intake. This condition can only be remedied by a substantial tax reduction in the lower and middle brackets.

Most of the great mass of people spend the money they get and from one-fourth to two-fifths live in poverty or deprivation. These estimates are supported by the Conference on Economic Progress report and other worthy compilations. Our economy will always be slack when so large a percentage of people cannot buy the many kinds of merchandise on the market. It accounts for thousands of small business people closing up each year. It accounts for unemployment. When 14 million self-employment people and small corporations cannot employ a few people in their business employment suffers.

We need to consider that the large corporations on the New York and American Stock Exchanges employ only about 24 million people. That condition leaves some 40 to 50 million to be employed mostly by small business.

We need also consider that 9 percent of our population, the older people above 65 years of age, are supposed to quit working and live on $25 to $32 per week social security benefits. Insurance statistics show that approximately 82 percent of the people above 65 years of age need to work, because they obviously cannot live on social security benefits alone. Our economy is unbalanced in that not enough money, this wealthiest country produces, goes back to the spending people for consumer buying. This problem must be solved if we are to avoid a costly depression.

INDIVIDUAL INCOME TAX SCHEDULE

We are in accord with the principle of tax reduction and curtailment of overspending. First things come first, however, and tax reduction is a first consideration. We find that the proposed tax bill, passed out of the House Ways and Means Committee, needs some revisions. The principal omissions center around too small a tax reduction in the lower and middle tax bracket schedule.

An analysis of the proposed tax schedule shows that a man and wife paying tax on $3,000 to $8,000 per year receive a 2-point reduction the first year. The couple paying income tax on from $8,000 to $12,000 per year receive a 2½-point reduction. The couple paying income tax on from $12,000 to $16,000 per year receive a 3-point reduction. The couples paying income tax on $100,000 and over, however, receive a reduction of from 9 to 14 points. Very obviously the schedule favors the upper brackets.

The small earner is not receiving sufficient consideration in this tax structure. There is no chance for savings, laying away for old age, for making small investments, or for business expansion. There is not enough money to buy even a few extra things many merchants need to sell. The "have-nots" would also like to accumulate a little money, but they can't even live comfortably because of the high tax bracket.

Those who make millions need consideration in the tax structure, for they are also overburdened with taxes. They do not need as much help as the consumer buyers. The millionaire and those in the upper tax brackets are taxed too high, but their consideration should not exceed that of the middle and lower brackets. Those who earn $50,000 a year will still have approximately $35,000 left to live on after taxes and for investment. This amount increases as one reaches the million dollar level. It is not investment that is mostly needed. The starting of a new business suffers if there are no merchandise buyers. Consumer buying and larger profits will increase dividends and put people to work and uphold expansion and economy. The price of stocks is out of proportion to earnings and dividends, so that investment in securities does not help to stabilize our economy.

We must consider, too, that the 1-percent social security tax increase in 1963 adds over 2 billions of dollars to our expenses.

The employment of domestic help would be increased and give jobs to many more unskilled people if there were tax consideration for the salaries of such employment. Domestic employment shoudd be considered in the same category as business employment and the wages and social security payments made deductible items from taxation.

CORPORATE INCOME TAX RATES AND RELATED MATTERS

We think that the corporation tax reduction from 52 to 48 percent is fully needed at this time. Within a few years it most likely should be reduced by 10 points or to 42 percent.

The reduction of the tax rate for small corporations from 30 to 22 percent is reasonable and necessary. The $25,000 ceiling should be raised to $100,000 or else the schedule should be graduated as follows: $25,000 income and less, 22 percent; $50,000 income and less, 30 percent; $100,000 income and less, 35 percent.

The small corporation does not have enough chance against the large and long-established corporations which accumulated their wealth when taxes were low. The cost of starting and maintaining a small business is difficult in the absence of large bank rolls. We shall soon reach the stage where small business

can't start or exist and that practice has destroyed every democracy the world has known.

CURTAILMENT OF UNNECESSARY AND WASTEFUL SPENDING AND CONCLUSIONS

We find that a tax reduction is necessary to the well-being of the people, and small and large business. Taxes should be reduced and then some action taken to curtail unnecessary and wasteful spending.

Our national debt must be reduced and the budget trimmed by at least $10 to $12 billion. We are paying over $10 billion interest on our deficit. Ninety billions of dollars are in bonds on which we are paying interest. People buy bonds under tax exemption; both activities add to our national debt and so-called back-door spending. The curtailment of needless and wasteful spending must have consideration. Our foreign aid contributions are excessive. The Common Market and other European countries are in better economic shape than our country, and still we are paying the heavy load for their defense. Our defense spending needs an overhaul. We have over 7,000 war bases in the world and many of them are obsolete. We are spending much more for keeping soldiers in foreign countries than the foreign countries are spending. We show much waste in subsidizing, stockpiling, and special privileges. Congress has the power to stop unnecessary and wasteful spending.

Although we need to expand in new enterprises, that alone will not solve our problem. Our plants are not working to capacity. We are not lagging in plant capacity. There is a lag in consumer buying of merchandise already manufactured. I does not help much to produce still more when the people do not have the money to buy what is being manufactured. Plants do not employ people unless they can sell their merchandise.

When the great mass of people do not have the money to buy and over 17 million people in the old-age bracket cannot buy products we have an unbalanced economy. Tax reduction is a necessity to maintain the economy. We need to consider that our population is increasing at the rate of over 4 million per year. The present allover figures on national income are, therefore, not a reflection of the needs of the people in the country. Our national income should be $40 to $50 billion higher. We need a clear-cut tax reduction.

We need to employ more people in industry instead of by the Government. This means that we will be paying wages to help the economy instead of employing people which adds to the tax burden. To keep the people poor to avoid inflation is deceptive propaganda. The wealthy people do not practice this preachment and we need not fear inflation because we adjust an unbalanced economy. Fair competition is a deterrent to inflation in a nonmonopolistic free enterprise system. In conclusion, I think it proper to say that tax reduction is a first necessity. A substantial tax cut should be made now. If we wait until the budget is first balanced there will never be a tax reduction. The Congress has the power to say how much we spend and upon passing the tax bill the necessary action can be taken to pare down budgets and excessive and unnecessary expenditures.

Thank you for the opportunity of making this statement.

DEER LODGE, MONT., *November 5, 1963.*

Senator MIKE MANSFIELD,
Senate of the United States,
Washington, D.C.

DEAR MR. MANSFIELD: Owing to the reductions that are proposed by the Government in income taxes, I presume that income tax provisions in general are being reviewed. One of the present provisions in particular is in my opinion in need of revision, which I can probably best explain by pointing out how we as a family are affected by it.

We have two invalid daughters, one of whom is confined to a wheelchair, and both of whom require a good deal of time and attention. So far, care has been provided chiefly by my wife who is a trained nurse. The time is rapidly approaching, however, when additional help will be essential in order for my wife to maintain her own health.

Under the present income tax provisions the amount paid to a person employed by us is deductible for income tax purposes only if that person is a nurse or practical nurse acting as attendant to our patients. If, however, we employ a person to perform household duties so that my wife may be freed to give more time to the care of my daughters the amount is not deductible. In other words, deductions may be made only in the case of persons employed to act as nurse, and not for performance of household work. We feel very strongly that the person most competent to care for my daughters is my wife, although we also realize that with advancing age it will become increasingly difficult for her to do so, and that we must become increasingly dependent upon the employment of others. Thus, as you will see, this inequity in income tax provisions will become a greater burden to us. We strongly feel that the cost of employing a person under such circumstances whether for nursing purposes or for household work, should be deductible for income tax purposes.

We trust that we can enlist your support for the tax revision, as proposed.

Yours sincerely,

LESLIE V. BELL,

U.S. Senator WINSTON L. PROUTY,
Montpelier, Vt.

DEAR SENATOR: Please find enclosed suggestions regarding changes in Federal income tax law and procedure.

These suggestions are made with the small taxpayer with limited resources in mind, to whom they would be a relief without reducing, in my opinion, the total tax collected. That figure may even increase.

The small businessman is being more and more neglected in our tax legislation, yet his income forms a large part of the tax base of the Nation.

In my experience as a registered public accountant, the depreciation item particularly, being a matter of opinion rather than fact, is used to get an extra tax dollar out of the taxpayer. The amounts involved per case are generally too costly to contest, but in the aggregate represent a tidy sum.

Is Uncle Sam so poor that he has to get the "mostest, fastest"?

Sincerely yours,

HEINZ G. KABELL,
Registered Public Accountant.

SUGGESTED CHANGE IN PROCEDURE TO TREAT UNDERPAYMENT OF ESTIMATED TAX

Example:

Assume Income Tax Liability of $ 1000.00, and Estimate payments of $50.00/Qu.

Date of Estimate	Amount of Tax	70% (Farmers 66 2/3%)	Part of Year	Due for 1 Year	Paid	Balance
4/15	250.00	175.00	100%	175.00	50.00	125.00
6/15	250.00	175.00	75%	131.25	50.00	81.25
9/15	250.00	175.00	50%	87.50	50.00	37.50
1/15	250.00	175.00	25%	43.75	50.00	(6.25)
				$ 437.50	$ 200.00	$ 237.50
				$ 237.50 & 6%		$ 14.25

Suggestion for Incorporation on Page 1 of Form 1040:

Income Tax Due	$1000.00		
43.75% of Tax	437.50		
Less Amount paid on Estimates	200.00		
Balance	237.50	& 6%	$ 14.25

To be added to Total Tax Due.

Eliminate the Penalty. Too many business men have their profits tied up in Inventories and Receivables. They therefore have to freeze part of their working capital in Estimate payments, and have in consequence to borrow money. Leaving Estimated payments against Future income taxes at the discretion of the individual may tend to increase the rapidity of the dollar turn-over, and thereby increase the tax base.

SUGGESTION FOR CHANGE IN DEPRECIATION SCHEDULE AND DEPRECIATION PROCEDURE

Description	Date Acqu.	Cost	Investment Credit	First Year Depreciation	Salvage Value	Prior Depreciation	Life	Depreciation
Totals								
Less Limits								
					→	→	→	
To Page 1, Form 1040					To Schedule C			

Leave Depreciation Life to the discretion of the taxpayer. If he over-depreciates, he will pay higher taxes in subsequent years.

BUT:

If he can take high depreciation in years when he has to make heavy payments for equipment purchases, he is more disposed to commit himself to these purchases.

In any event he cannot depreciate in excess of cost less credits.

This procedure may tend to increase the rapidity of the dollar turn-over, and thereby increase the tax base.

STATEMENT OF MITCHELL B. CARROLL, REPRESENTING THE FREDERICK SNARE CORP., RE AMENDMENT 333 OF H.R. 8363 SUBMITTED BY SENATOR LONG, CONCERNING LOSSES FROM FOREIGN EXPORTATIONS

Mr. Chairman, and members of the committee, I am Mitchell B. Carroll, an attorney representing the Frederick Snare Corp., a construction and engineering company organized in 1902 under the laws of the State of New York. In addition to its activities in the United States it has operated in Latin America continuously during its entire existence and has a history and reputation of consistent accomplishment in that area.

This corporation has operated in Cuba 58 years and has done much work for the U.S. Government at the Guantánamo Bay Naval Station in addition to serving United States and locally organized corporations in that country in engineering and constructing many port works, industrial plants, and other projects of all types and sizes.

The corporation and its wholly owned U.S. subsidiary conducted its business in Cuba through branch offices, and in addition had a small investment in a wholly owned Cuban company which was formed to own floating equipment needed in its operations that under Cuban law could not be owned by a company foreign to Cuba.

On the morning of October 7, 1960, a vice president of the corporation, who was manager of the branch in Havana, received from a Cuban naval officer who was acting on behalf of the ministry of labor, a document containing Resolution No. 21632 issued under the authority of law 647 of November 24, 1959, and law 843 of June 30, 1960, which ordered an intervention for a period of 1 year. The intervention was extended to cover both the American subsidiary and the Cuban subsidiary.

On October 14, 1960, protests were addressed to the ministry of labor asking for the termination of the intervention of the three companies but no replies were received.

The interventor continued operations, with the aid of employees of the corporation, until sometime in February 1961. An officer of the corporation received a letter dated February 21, 1961, that the company was "being dissolved"; that the department of public works would take over the few contracts and projects and carry them out; that the equipment was being distributed between the department of public works and the department of farm dwellings; and that no official resolution taking over the property had been issued but the officials were acting as if it had. The letter added that the employees would be absorbed, some by one of these departments and some by the other.

A letter dated May 16, 1961, said that everything was being moved and the intention was to finish before the 31st of March. Still there had been no official notification of the dissolution of the company. Hence the confiscation of the company evidently was completed as of the end of March 1961. The book value of its confiscation losses is about $1,200,000.

Under present law the corporation cannot obtain adequate tax treatment in writing off its Cuban confiscation losses. The basic reason is the requirement of the law that a net operating loss be carried back 3 years before being carried forward 5 years. Carrying back would necessitate the converting of large amounts of foreign taxes of prior years from credits against U.S. income taxes to expense deductions, while, ironically, generating very small refunds of U.S. taxes of prior years. The bulk of the total possible tax benefit, therefore, even though already severely reduced by carryback requirements, would be only a potential one obtainable against future earnings. In this latter respect I would like to point out that the corporation suffered an overall loss in each of the years 1960, 1961, and 1962 and will have suffered another in the year 1963. Accordingly the balance of time remaining under present law for the corporation to generate the earnings necessary for it to obtain even the inadequate tax benefits possible is severely limited.

The severe hardship to the corporation that I have set forth results from the fact that it is a relatively small business with profits normally at a level at which it is not possible for it to absorb an extraordinary loss of the magnitude of its Cuban seizure loss against the profit of any year without a net operating loss resulting. Said normal level of earnings as it was prior to intervention in Cuba worsened appreciably with the advent of Castro in 1959, as there was an immediate contraction of its ordinarily substantially profitable Cuban operations.

The corporation's efforts to broaden its operations to and in other locations

on a sound basis in order to fill its earnings vacuum have resulted in slow progress largely because of the heightened critical political and economic conditions in Latin America, its principal area of operations for many years. The corporation has not yet turned the corner to profitable results.

We support most earnestly amendment 333 of H.R. 8363 submitted by Senator Russell B. Long on November 27, 1963, in all of its major provisions, including those concerning recoveries in future years, as an amendment that will give Frederick Snare Córp. a reasonable chance of obtaining adequate relief in its predicament. Additionally it would give small businesses generally a greater incentive to go foreign.

However, we respectfully purpose two clarifications.

In the first place, we strongly favor that amendment 333 permit the corporation to elect to carry over a net operating loss but it should be made clear that the carryover applies only to the extent of the foreign expropriation loss to each of the 10 taxable years following the taxable year of such loss.

Secondly, we urge that the language in the proposed new subparagraph (C) of section 172(b)(3) be clarified to make it certain that if any taxable year is reopened for assessment under this subparagraph the taxpayer shall, notwithstanding section 901(a), IRC, be permitted to change its choice as to the deduction or credit of foreign income taxes for any taxable year which is so reopened and for any other taxable years which affect or are affected by the reopened years. Other taxable years affect or are affected by the reopened year, for example, through the influence of net operating loss carrybacks and carryovers and the unused foreign tax credit carrybacks and carryovers.

These proposals have been submitted to Senator Long and to the Treasury, and they are explained more fully in a letter addressed to Senator Long which is submitted herewith for the record.

The corporation has submitted data concerning its situation to the Treasury and will be glad to give to the committee any pertinent information that it may desire.

FREDERICK SNARE CORP.,
New York, N.Y., October 29, 1963.

Re S. 2058.

Senator RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: We have read with great interest the provisions of S. 2058, which you introduced on August 15, 1963. We are very appreciative of your interest in providing relief for American business organizations which suffered heavy losses as a result of the actions of the Castro government in Cuba.

We favor enthusiastically the form of relief provided in the bill. Our own expropriation losses exceed $1,250,000, and in addition we have incurred very substantial operating losses beginning with the year 1960 and continuing to date. It will take us a long time to recover financially from the effect of these losses.

In order to carry out more effectively the purposes of the bill, we respectfully suggest that the following technical amendments, would be in order:

1. In proposed new subparagraph (D) of section 172(b)(1) (p. 2, lines 9 to 18 of the bill), insert after "net operating loss" in line 13 the words "to the extent of such foreign expropriation loss."

The effect of this amendment would be to permit a net operating loss in excess of the foreign expropriation loss to be carried back 3 years and forward 5 years under existing rules, even though the 10-year carryforward (with no carryback) was elected for the foreign expropriation loss. The amendment is needed to prevent a small foreign expropriation loss, perhaps as little as $1,000, from determining the treatment of net operating losses which could run in the millions.

2. The language of the last sentence of the proposed new subparagraph (C) of section 172(b)(3) (p. 3, lines 9 to 13 of the bill) is vague. The sentence should be redrafted to make clear that if any taxable year is reopened for assessment under such subparagraph, the taxpayer shall, notwithstanding section 901(a), be permitted to change his choice as to the deduction or credit of foreign income taxes for any taxable year which is so reopened and for any other taxable years which affect or are affected by the reopened years. Other taxable years affect or are affected by the reopened year, for example, through the influence of net operating loss carrybacks and carryovers and unused foreign

tax credit carrybacks and carryovers. We see no objection to permitting the taxpayer to change other elections, but we believe that it should be made very clear that the treatment of foreign income taxes can be changed.

The following example illustrates the problem:

A taxpayer suffers a foreign expropriation loss in 1960 which results in a net operating loss for that year in excess of the combined taxable incomes for 1957, 1958, and 1959. Under the law currently in effect, the net operating loss is carried back and results in refunds of tax paid for those years. In order to maximize the carryover to subsequent years, the taxpayer elects to treat foreign taxes as deductions in each of the years 1957 to 1960, inclusive. Assume that S. 2058 is enacted. By the time the taxpayer elects the application of its provisions pursuant to code section 172(b)(3)(C)(i), 1957, 1958, and 1959 are statute-barred and are reopened by section 172(b)(3)(C)(ii) as a consequence of the election. The disallowance of the carryback from 1960 makes it advantageous for the taxpayer to treat foreign taxes in 1957, 1958, and 1959 as a credit. Also, if the foreign taxes for either 1958 or 1959 are in excess of the limitations on the credit, section 904(d) would permit a carryover of the excess taxes to subsequent years, and a carryback of excess tax for 1959 to 1958.

Any change in the treatment of foreign taxes as credit rather than as a deduction would be prevented, under the facts in the example, by code section 901(a), in the absence of a contrary provision in S. 2058. For this reason, it is important that S. 2058 be clear and unambiguous on the point.

We shall greatly appreciate your consideration of these proposed technical changes in your bill. We shall be glad to furnish further information regarding them or to confer with any person you may designate.

Sincerely yours,

JOHN F. MYSLIK,
Secretary and Treasurer.

AMERICAN APPAREL MANUFACTURERS ASSOCIATION, INC.
Washington, D.C., December 4, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: I have been instructed to communicate with your committee on behalf of the board of directors of the American Apparel Manufacturers Association, Inc. This association is composed of apparel manufacturing firms producing all major lines of apparel located in 44 States and representing approximately $3.5 to $4 billion in apparel volume at wholesale, and maintains its offices at 2000 K Street NW., Washington D.C.

This is to advise you that this association is in favor of the tax reduction provisions of H.R. 8363. The association has concluded that it is appropriate at this time to reduce in some measure, the confiscatory income tax rates that have existed in this country since the beginning of World War II.

The association feels that it is necessary for the soundness of the economy that this move be made. One need not be an economist to realize that a major source of investment capital must be the savings of upper income individuals.

It is unfortunate that the provisions of the present version of H.R. 8363 actually increase the progression in tax rates and by concentrating the bulk of tax reduction, place more emphasis on consumer demand than on freeing investment capital.

However, H.R. 8363 does grant some relief from confiscatory rates, and in this respect should eventually benefit the entire economy.

The association is taking this position at this time, particularly in view of the several assurances within the past week by the President of the United States, that $1 worth of value will be obtained for each $1 spent by the United States. These assurances, together with President Johnson's admonitions in respect to frugality to various Government departments, agencies and contractors, have given us hope that this administration will seek to have a fiscally responsible Government.

It should be pointed out that our endorsement of the tax cut provisions of H.R. 8363 does not mean that we endorse the other provisions of this bill, and we do not make any comments in respect to the changes other than those dealing with rates.

We respectfully request that this letter be made a part of the written record compiled by your committee in its consideration of H.R. 8363.

Sincerely,

ELLIS E. MEREDITH, *Executive Vice President.*

U.S. SENATE,
December 2, 1963.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR HARRY: Reference is made to section 206 of the proposed Revenue Act of 1963 (H.R. 8363), concerning the exclusion from gross income of gain on the sale or exchange of a residence of an individual who has attained age 65. I have a particularly intense interest in this single provision inasmuch as similar legislation was introduced in the Senate with my cosponsorship for the last two Congresses.

It has come to my attention that section 206 as presently drawn may work an inequity in a narrow class of cases where only one of two spouses has attained age 65.

Under section 121(d) of the Internal Revenue Code, as it is proposed to be amended by section 206(a) of the bill, a total or partial exclusion of the realized gain would be available to a married couple filing a joint return where the property is held by them as joint tenants, tenants by the entirety, or community property—even if only one of the spouses satisfies the age, holding, and use requirements of section 121(a) with respect to such property. Similarly, the same treatment would clearly be available to a married couple filing a joint return where the spouse who satisfied the holding and use requirements has attained the age of 65 before the date of sale or exchange—even though the other spouse has not.

However, upon close analysis of section 121(a), it would appear that the special tax treatment would not be available to a married couple filing a joint return where the spouse who satisfies the holding and use requirements has not attained the age of 65 before the date of sale or exchange—even though the other spouse has. Thus, to take a common situation, section 121(a) in its present form would not apply where the husband is over 65 but it is the wife, aged 62, who holds title and otherwise satisfies the holding and use requirements set forth in the section. In order to derive any benefit from the provision, the couple would have to wait 3 years before selling or exchanging the residence, regardless of the immediacy of their need for the proceeds of the sale or exchange. Since the rationale of the provision is based on the likelihood that the over-65 taxpayer may—in the words of the House committee report (p. 45)—"require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses," it is my strong feeling that in the factual situation just detailed the couple ought to get the benefit of the provision even though the wife has not yet attained age 65.

In my judgment, the section ought to be amended so as to provide that where (1) a married couple files a joint return, (2) one of them satisfies the age 65 requirement, (3) the other satisfies the holding and use requirements but has not yet attained age 65 and is 60 years or older, then the treatment is available. I have suggested age 60 as the minimum age for the under-65 spouse so as to limit the applicability of the section to cases in which the need is probable, and also to minimize revenue losses to the Treasury.

Such an amendment, it seems to me, would avoid discrimination in treatment between the couple in the case I just posed and a couple who, by dint of happenstance, hold jointly as described in section 121(d) and thus can take advantage of the provision even though only one spouse has attained age 65.

I am respectfully requesting your committee to give careful consideration to my suggested amendment, and if I can be of any assistance to you in this matter, please do not hesitate to call upon me to discuss it with you or other members of the committee at any time.

With warm regards,

Very sincerely yours,

KENNETH B. KEATING.

STATEMENT OF CYRUS T. ANDERSON IN FAVOR OF S. 2068, AN AMENDMENT PROPOSED BY SENATOR LONG, OF LOUISIANA, TO H.R. 8363, TAX BILL

This testimony is submitted to the Senate Finance Committee by Cyrus T. Anderson, Washington representative of the Hotel & Restaurant Employees & Bartenders, International Union, AFL-CIO, at the request of our president, Ed S. Miller. Our labor union represents nearly 500,000 men and women whose work covers the services involved in feeding, lodging, and refreshment. We are submitting our statement in writing, rather than appearing personally, because of the committee's request that we do so. We will be pleased to answer questions of the committee, if they have such questions, in the same manner as if we had appeared personally.

Our union is obviously not composed of wealthy people. As we understand the reasons for the enactment of the present expense account law, it was designed to overcome expense account abuses, particularly involving facilities, and the publicity generated at that time spoke of "hunting lodges and African safaris" financed as business expenses by those wealthy groups and individuals who were abusing the expense account laws and regulations.

There was talk that the Treasury would gain an additional $100 million by tightening up in this area.

There was no talk then, and certainly there was no intent in the new law or regulations to destroy income and jobs of our economically modest labor union members. But the fact is that the new law has definitely resulted in a lowering of income and a loss of jobs among our membership. We would also question what Treasury's estimate of income would now be in view of nearly a year's experience with a complicated law and regulations dizzying in detail, which have so inhibited legitimate spending.

Our membership is hurting, employmentwise and incomewise. We know this because, like most effective labor unions, we are close to our membership. But to furnish the statistics in detail is unfortunately just not possible.

A very large portion of our membership is not covered by minimum wage laws. A large portion of most of our members' earnings (tips) are not covered by social security. Therefore, Federal and other statistics, including our own, do not reflect a true picture of reduced hours of work, reduced income through such shorter hours, and lesser tips because of reduced hours, and reduced liberality on the part of those on expense accounts.

However, we did make as thorough a survey as possible early this year for a meeting of the Senate Finance Committee with Commissioner Caplin on February 28. This meeting had been suggested by Senator Smathers. We submitted detailed income and employment figures, to the best of our ability, for seven major cities—New York, Detroit, Chicago, St. Louis, Milwaukee, San Francisco, and Los Angeles. Each is an important convention, hotel, and restaurant city, and as we said then, "While our survey is by no means complete, it clearly reflects the alarm felt by our representatives, all widely experienced in the industry's labor supply problems, and by responsible businessmen in a position to known intimately the already grave consequences of the IRS's new posture in respect of travel and expense items in the businessman's budget."

Because our testimony was as detailed as possible at that time, and because the situation remains at least as bad now, and in the interest of conserving the time of the committee, I would like to include the testimony of February 28, 1963, as part of my present testimony. It covered spot checks of other cities, in addition to the seven mentioned above.

The Financial Executives Institute, formerly called the Controllers Institute, representing 5,600 financial executives, strongly favored S. 2068 in their testimony before this committee on November 21, 1963. So have other business groups supported S. 2068, including the Chamber of Commerce of the United States, the National Association of Life Underwriters, the National Club Association, and others.

S. 2068 to be introduced as an amendment to the revenue bill by Senator Long, has 19 other Senators as cosponsors, including four members of this committee. Our union believes that this amendment (an identical bill has been introduced by Representative Hale Boggs in the House) will reverse the present confused and awkward situation, which is hurting employment and income.

We respectfully ask your support of it in committee, and on the floor of the Senate. Thank you.

STATEMENT OF CHARLES J. SANDERS, JR., VICE PRESIDENT, SALES AND MARKETING EXECUTIVES-INTERNATIONAL

First of all, I want to thank the committee for this opportunity to testify, in this important bill before the Congress. My name is Charles J. Sanders, Jr. I am president of C. J. Sanders Co., Nashville, Tenn., and vice president for the southern region of Sales and Marketing Executives-International, an association of 25,000 sales and marketing people from every State in the Nation. We have 175 domestic clubs in major cities of the country, and our membership includes executives of most of the major companies in the United States. Sales and Marketing Executives-International is dedicated to the promotion of better standards of living through better selling and marketing. The organization is a clearinghouse for much valuable information on selling, sales management, and marketing practices.

I am here today because of the intense interest of our member clubs and the companies they represent, in the pending tax bill. The final form of that bill, as written by this committee and enacted into law by the Congress, will have a profound effect on the economy of our country for years and decades to come. I hope to be able to show that the salesman's stake in this bill is as great as his stake in the growth of the economy.

One of the purposes of this bill is to keep the economy moving upward, and to eliminate some of the unemployment problems that are now plaguing the country.

Salesmanship is an important factor in moving the economy forward. Arthur (Rei) Motley, president of Parade Publications, and a former president of Sales and Marketing Executives-International, once made the statement that "nothing happens until somebody sells something." Certainly it is true that production is no longer a problem of the American economy. Our plants could produce considerably more tomorrow, if they were to receive the requisite number of orders today.

I submit that the primary task of the salesman is to go out and get those orders. Anything that comes between the salesman and his potential customers work against building up backlogs of orders, the very backlogs that we depend on to reduce unemployment.

A salesman is a special kind of man. By his very nature, the salesman who is good at getting the order is going to balk at keeping detailed records. I mean detailed records of any kind. As a sales manager, I can testify that I have trouble getting my men to write down the details of the calls they make, information about their prospects, details of conversations and the like. A good salesman can remember all these things himself, but it is difficult to get him to pass this kind of information along. And it is doubly difficult to get him to write down the purely arithmetic details of how much he has spent, where he spent it, and for what purpose. To him, these details are irrelevant, as long as he is bringing in plenty of good, profitable business. And he reasons that increased business for his company works for the good of the whole economy.

The Los Angeles Sales and Marketing Executives Association recently made a study of 97 star salesmen, representing all types of selling. Each man took tests measuring his comprehensive mental abilities, personality, and motivation. He also filled out personal history forms, and his employers rated each man according to his basic behavior traits. The characteristics revealed by these men would hardly qualify them as accountants. Although their numerical reasoning ability was in the 90th percentile, as measured against all men, their interest in computational and clerical tasks fell in the 20th percentile. In other words, gentlemen, these star salesmen, the best that could be found in the companies represented in our Los Angeles club, are capable of filling out the detailed forms requested by the Internal Revenue Service, but, frankly, these men feel they have more important things to do with their time. They are interested in people, and in influencing people to take action. I submit that these are the men we need to keep the economy moving, and we ought to listen to them on a matter like this.

It is the opinion of Sales and Marketing Executives-International members that amendment 229 will help the salesman who has legitimate sales expense, and who is driven to distraction trying to provide all the proof required by present provisions. It is the efficient salesman we are concerned with here—the man who at present is required to give up to accounting time that he can spend much more profitably in selling.

If amendment 220 is not passed, we can foresee cases where excellent salesmen will seek other employment altogether. Any and every time that a good salesman quits his job out of sheer frustration, the stated purpose of the tax law—to inject life into our economy—will be defeated.

Gentlemen, is it not logical to assume that entertainment and travel should be treated the same as any other sales or production expense? Will not those companies whose entertainment and travel expenses are too high soon realize that they are not getting the proper return on their money, and either change their ways or lose out to more efficient companies? Will not the law of diminishing returns rectify any expense account abuses? How much must the economy as a whole pay to ferret out the abuse of the few?

And finally, if the Federal Government were bearing less than 50 percent of the cost, corporations would very definitely have more of a stake in reducing all of their costs, not simply travel and entertainment expense. Perhaps this would be the best way to get the economy moving again.

A Federal tax structure that will provide an equitable distribution of the tax burden, and an incentive to work will release new money for capital investment and this is certainly conducive to economic growth and stability.

Once again, let me thank you for this opportunity to testify before you on this important piece of legislation.

STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION, WASHINGTON, D.C.

Mr. Chairman and gentlemen of the committee on finance, I am Vernon Herndon, senior vice president of Hilton Hotels Corp. and a member of the governmental affairs committee of the American Hotel & Motel Association.

The American Hotel & Motel Association represents over 6,000 hotels and motels in the United States, and actually speaks for about 90 percent of the first-class hotel rooms in the country. The Nation's hotels, motels and resorts are generally referred to as the Nation's seventh largest industry. We welcome this opportunity to inform you of the grave and overwhelming burden cast upon the great innkeeping profession by the Revenue Act of 1962 and subsequent regulations.

We strongly urge that this committee adopt the provisions of S. 2068 as an amendment to H.R. 8363, the proposed Revenue Act of 1963.

More than a year has elapsed since Congress passed the Revenue Act of 1962, a law including certain amendments to the Internal Revenue Code to restrict the deductibility of business travel and entertainment expenses. It has now been more than 6 months since Internal Revenue Service issued the last of its regulations implementing these amendments.

The American Hotel & Motel Association is convinced that this interim has proven sufficient for an extended and penetrating study of how this legislation has affected our industry.

When the rules first issued, the immediate impact was a sharp and serious downtrend in all facets of innkeeping that serve the businessman. Today, unfortunately, we find that time has not healed this wound. Any return to normal spending has been sporadic and isolated at best. Convention attendance is still far below average. Banquet and catering schedules are still going unfilled. Room occupancies are at an alltime low. Food and beverage sales stay below their normal patterns. In short, the average businessman has yet to recover from the financial paranoia forced on him by the travel and entertainment provisions of the Revenue Act of 1962.

Before getting into specific examples of the effect of the Revenue Act of 1962, I would like to make a few general comments.

To begin with, the amendments have been unfair to the businessman-taxpayer. They have burdened millions of honest and prudent taxpayers in order to curb a handful of offenders. Let me state at the outset that this association is in full accord with any Government actions to punish those who defy or abuse the laws of our land. However, in this case we find that an unduly harsh law has only defied and stifled the free flow of our economy.

Last year's amendments were particularly ill timed in that the Internal Revenue Service had just opened its new data processing center in West Virginia, and had added some 3,000 agents to its staff. One of the major purposes of both actions was to expand the auditing of individual tax returns. These steps have in themselves reduced expense account abuses and have rendered these stringent amendments and regulations unnecessary.

The regulations issued by Internal Revenue Service are cumbersome. They consume over 100 pages of fine print. Experienced tax attorneys are incapable of understanding them. Commissioner Caplin recognized the complexity of the problem when on September 27, he began a 3-month special training program for his 14,000 revenue agents. Apparently this program is continuing as of this date. The nontax expert, the ordinary citizen, on the other hand, was provided with "simplified guides", better known to mountain climbers as simple guides.

The language is ambiguous. For example, one of the most important phrases in the amendments enacted by Congress prohibits deductions for "lavish and extravagant" entertainment. Yet the subsequent regulations give the businessman no clue in determining just what constitutes these conditions.

It has been stated instead that such interpretations are to be left to the courts. This is precisely our bone of contention. In the past such questions have also been settled by judicial interpretation. If this then is still to be the case, the amendments and IRS regulations are clearly unnecessary.

There are already signs of overenforcement. Despite public assurances to the contrary by the Commissioner of Internal Revenue, we have already begun to receive reports of overzealousness by IRS agents in the field. This very real danger is the logical product of the ambiguities mentioned above—and of the oft-distorted array of publicity surrounding the issue.

The end result has been confusion. All of the above conditions have created an artificial cloud of uncertainty among businessmen. Most are not schooled in the intricacies of tax law; and since it is human nature to "fear the worst" when confronted with a forbidding obstacle one cannot understand, most businessmen have displayed a timidity in pursuing even the most acceptable forms of travel and entertainment. This in turn has curtailed activities that would ordinarily be regarded as beneficial and necessary to the conduct of business.

I would now like to point out how these amendments and subsequent regulations have affected just one important segment of our economy—the Nation's lodging industry.

They have created unemployment. Some specific examples are mentioned later. Industry authorities have estimated that job layoffs among hotel and restaurant workers will run as high as 140,000 before these industries adjust themselves fully to the amendments. Exactly how many have already been force dout of work is, quite frankly, impossible to compute. But we can state emphatically, based on letters and personal discussions, that the impact on employment has been substantial.

They have caused the Government greater losses in tax income than have been gained through the new powers of enforcement.

Again, by manacling thousands of innkeepers and businessmen in redtape to pursue a few unscrupulous individuals, the Federal Government has cut off its nose to spite its face. Every hotel or motel room left vacant by a canceled convention, every darkened banquet room, and every empty restaurant will be reflected collectively by lower tax revenues at all levels.

As this committee so well knows, chronic budget deficits pose as crucial a problem as any facing our Nation today. Thus, we must again question a law inconsistent with our national ideals—in this case a law that has suppressed the normal flow of tax revenues to the Treasury.

Their impact is felt not only by lodging places—but by every community. The economic health of the country suffers in the final analysis.

Business travel and entertainment dollars are by no means the exclusive property of innkeepers. For example, 85.7 percent of each dollar of hotel income is distributed directly to the community. A recent study breaks down this sum as: wages, 37.7 cents; cost of food and beverages sold, 14.7 cents; operating supplies and expenses, 23 cents; taxing authorities such as real estate, social security, and Federal income tax, 10.3 cents. The rest of the dollar is reserved for depreciation (6 cents) and for rent, interest, and return on investment (8.3 cents).

They have harmed lodging places of all types—and in all parts of the country.

As an association representing hotel-motel management, we regard this as an extremely crucial point. Part of the reason is that many critics have been quick to dismiss reports of declining sales as the results of normal competition in a fast-changing industry. Some insist that the affect of the amendments has been limited to rundown city hotels, certain types of resorts, or some particular segment of the industry "not in tune with the times."

Both statements could not be further from the truh. The American Hotel & Motel Association has found that the serious impact of these laws has cut across all of our more than 6,000 members. These include new establishments and old establishments. They include chain properties and independents. They are large and small. Their locations range from the smallest prairie village to the hubs of our industrial might. In short, they include every type of lodging place catering to the traveling businessman.

I am listing below excerpts of representative letters received since September 1963 by our association. Since space will not permit all of them, I shall include only a partial list of comments from States represented by the members of the Finance Committee.

Motels have been adversely affected without regard to location or size of city. In Ivorytown, Conn., a small inn reports that the expense account amendments have been "largely responsible" for a 20-percent decline in all types of sales. A beachfront motel in Sarasota, Fla., lists an $11,800 drop in room sales for the first 8 months of 1963. In bustling Cocoa Beach, Fla., a motel that thrived last year reports 1963 sales declined 38 percent in rooms, 44 percent for food, 35 percent for beverages, and 28 percent for group meetings. The manager writes that "while most business guests did not mind the closer scrutiny of their records, the biggest complaint seemed to be the added burden of keeping more records."

In Norfolk, Va., a modern motel attributes a $4,000 decline to the travel and entertainment rules. Outside Indianapolis, Ind., a small 25-unit motel has already dropped $10,000 in room sales and $48,000 in food revenue since January. A Santa Fe, N. Mex., motel complains that room sales have declined $12,787 so far this year; 1962 sales, reflecting the first impact of the amendments, were down $14,000 from 1961. In Lafayette, La., a motor inn proprietor writes that after an 8-month decline of about 10 percent, "we have had to lay off three people, about $3,500 in payroll and pay cuts of others amounting to several thousands of dollars * * * we think the IRS rulings are mostly responsible for these adverse conditions."

Large urban motor hotels, generally the newest and most prosperous industry segment, have not be spared. From Minneapolis, a motor hotel manager writes that "firms that used to run four regular sales meetings per year have cut back to one and two for fear of IRS repercussions. Legitimate entertainment," he adds, "has been curtailed to the point of being ridiculous."

The same is true in Indianapolis where the affiliate of one of the Nation's largest chains lists a total $85,886 decline in the first 8 months of 1963. Its owner writes that "this is all reflected by the new expense account law. I have had to cut my employees by 10 persons."

Here are some other typical motor hotels:

Kansas City, Kans.: Room sales down 18 percent; food sales down 11½ percent; convention sales off 10 percent. "We have found that since the new ruling attendance has fallen off in almost all cases of conventions. * * * Everyone seems to be in a quandary. So rather than take any chances, they just don't spend the money."

Portsmouth, Va.: Room sales down 11 percent so far this year. Food sales off 24 percent. "Our business is 85 percent commercial traveling men."

Tampa, Fla.: Food and beverage sales down $76,000. "With an increase in room sales and so significant loss in convention sales for the comparative period, the loss in restraurant sales can only be due to the IRS regulations. Decrease in payroll for the comparative period amounted to approximately $25,000."

Minneapolis, Minn.: "1962 net profit, $81,408; 1962 Federal income taxes. $40,000; 1963 net loss $16,283. Federal income taxes, none. Payroll has been reduced from 455 to 409."

Resorts of all types and locations have suffered seriously from the regulations. Florida, so dependent on travel and conventions, offers an alarming example of losses that have in some cases been staggering. One gulf coast resort reported a combined plunge of $140,000 in room, food, and beverage sales as of mid-October. One of the leading Miami Beach resorts dropped $500,000 in convention sales alone. Its room, food, and beverage revenues are $270,000 behind last year. Further north on Florida's east coast, one of the Nation's largest and best-known resorts reports the following: Room sales down $60,400; food sales off $65,000; beverage sales down $60 400; convention sales down $134,000.

Intown hotels, always the focus of business conventions, have been harshly affected regardless of their location, age, or size. The following comments indicate the extent of the damage:

(Ocala, Fla. ($14,730 decline): "We have eight fewer employees than a year due to the * * * decreased sales. We believe this is due, at least in large part, to the Revenue Act of 1962 and subsequent regulations on travel and entertainment."

Lexington, Ky. ($49,565 decrease): "Our loss * * * is mainly in the food and beverage departments. The above figures merely reflect loss of revenue. Our chief concern is increased costs. * * *"

Richmond, Va. (down $132,000): "Attendance at expense-paid conventions fell 30 percent short of expected attendance at the time the conventions were booked. The nonexpense paid conventions came much closer to meeting the attendance estimates. We can only conclude, therefore, that the travel and entertainment regulations caused the drop in expense-paid convention attendance."

Atlanta, Ga. ($318,000 drop): "* * * we know that convention sales will reflect a large decrease and that convention guests are spending less in the current year. The overall decrease in sales is about 16⅔ percent and we are operating at a loss."

Salt Lake City, Utah (down $79,518): "All evidence, research, and records clearly indicate that we are suffering a definite loss in volume due to the IRS regulations on expense account spending. This, in turn, has forced us to reduce our staff."

Wichita, Kans. (down $12,000): "Our payroll is running about 5 to 7 percent below last year, or about three employees less."

Other recent letters in our files reflect a similar reaction from intown hotel managers throughout the country. A partial but representative list would include hotels in:

Albuquerque, N. Mex.: Sales for first 8 months of 1963 show rooms down $21,272, food down $31,476, beverages down $26,921.

Baton Rouge, La.: Rooms show $83,587 drop; food, $24,841; beverages, $26,921.

Chicago, Ill.: Total losses of $153,049 for first 7 months of 1963. All but $2,000 of it was sustained by the food and beverage department.

Hartford, Conn.: 1963 sales running $33,000 behind. Room sales alone down 12 percent.

Hibbing, Minn.: Food loss of $50,000 compared to same period last year. Total decline of $73,500.

Minneapolis, Minn.: Total sales drop of $270,000. Decline of 27½ percent in room sales, 12 percent in food, 14 percent for beverage, and 22 percent in convention revenues.

Quincy, Ill.: Decrease in room sales of $14,227. Food and beverage drop of $19,741.

Savannah, Ga.: Total loss for first 8 months of $32,164. "No let up in sight."

Shreveport, La.: Rooms down $28,000; food, $24,000; beverage, $5,000. Total decline to date: $57,000.

Tampa, Fla.: Room sales off $23,230. Total loss: $42,599.

Valparaiso, Ind.: Overall 15⁸⁄₁₀ percent decrease in revenue from 1962.

Wilmington, Del.: Room sales down 18 percent. Food sales down 22 percent. Beverages off 29 percent. "From 1958 to 1962 business was increasing consistently."

These, as well as other examples included in this statement, were taken from correspondence received since September. I would like to stress that the files of the A.M. & M.A. Washington office contain hundreds more letters dated from the time the travel and entertainment amendments made their unwelcome debut, to the present.

While the names of individuals and their establishments had to be eliminated from this statement for obvious competitive reasons, they are nonetheless very real. Their concern is very real. Their problem is no less urgent than it was a year ago or 6 months ago. At this very moment many familiar landmarks throughout the United States are struggling for their very existence due to the amendments in the 1962 Revenue Act and their subsequent regulations.

It is for the foregoing reasons and for many more like them, that we ask for relief from the widesweeping provisions of the Revenue Act of 1962.

We believe that the provisions of S. 2068 will restore confidence to the taxpayer in the legitimacy of proper travel and entertainment deductions. At the same time, we believe it offers the Internal Revenue Service a potent enough weapon to root out expense account abuses. It will bring back reason and sanity

to the enforcement of our tax laws and do away with the present arbitrary and unrealistic approach to travel and entertainment expenses.

We strongly approve the retention of the investment provisions in the present law as these have been of great benefit to hotels and motels in modernization programs. Modernization of older properties is particularly essential in the hotel and motel industry to meet the competition of new establishments being built in all parts of the country.

We further support the amendments to the investment credit provisions as contained in the House bill now pending before your committee. We refer particularly to the amendment which repeals the provision requiring adjustment of the tax base of the property and the amendment making elevators and escalators eligible for the credit. We believe both of these amendments will be of particular benefit to hotels and motels and effectuate the basic purpose of the law to encourage legitimate and sound investment.

STATEMENT OF THE GOVERNMENT EMPLOYEES' COUNCIL, AFL–CIO

Mr. Chairman, and members of the committee, the Government Employees' Council is comprised of 25 AFL–CIO unions representing various categories of Federal Government workers. These member unions serve as spokesmen for three general classes of Federal workers—postal employees, classified, or white-collar employees and craft or blue-collar employees.

The purpose of our presentation is to underscore those portions of the President's tax proposals affecting retired Federal workers. In general, the result of the President's recommendations would require at least some of them to increase their tax payments.

At this point, it should be emphasized that the council endorses the general desire to achieve overall tax reductions to stimulate the economy. With the slow but persistent growth in the numbers of unemployed, it is apparent that steps must be taken to accelerate the economy to provide jobs for those now without work and to accommodate the huge number of younger men and women who will enter the labor market during the next decade. Hence, we support the basic purpose of the tax plan. Another important objective is the introduction of increased purchasing power in the hands of consumers to energize the economy. With this we agree also.

We are concerned, however, with the effect of the present law and a provision in H.R. 6383 on retired Federal workers, their widows and survivors.

Originally it had been proposed to substitute for the present retirement income credit of $1.524 and the additional exemption at age 65 a $300 tax credit. As approved by the House, H.R. 8363 the provision in section 37(d) of the Internal Revenue Code without modification. We urge that the Senate Finance Committee not revise the present retirement income credit on this score.

Section 105(d) of the code amounts paid by an employer to an employee when the latter is ill or injured can be deducted from the employee's gross income. The exclusion is available up to $100 per week. Where sickness results in an individual's absence from work, the exclusion is available only after the first week, unless the employee is hospitalized for at least 1 day.

Section 205 of H.R. 8363 continues the $100 figure on excludable income, but makes it available only for absences of more than 30 continuous days, regardless of whether an injury or sickness is involved.

Those Federal workers who find it necessary to retire for disability prior to attaining normal retirement age may now consider up to $100 as excludable sick pay after only 1 week or 1 day if hospitalized. We believe this consideration should be continued for these specialized types of retirement.

For some years, the council has advocated removal of income taxes on civil service annuities.

This is now the case with pensions under the Railroad Retirement and Social Security Acts. The exemption was included specifically in the railroad retirement system when the statute was enacted in the 1920's. Application by the Internal Revenue Service of a Supreme Court decision to the social security law in the 1930's resulted in the income tax exclusion on these benefits.

Underlying these actions was the valid premise that income taxes should be based on "ability to pay." We submit, Mr. Chairman, that this rationale applies today with equal logic to the pensions of retired Federal workers.

More than 30 percent of present civil service retirees receive monthly benefits less than $100. Forty-nine percent of Federal annuitants have benefits below $150. Certainly, the conclusion is justified that these men and women have a very limited "ability to pay."

In a restricted sense, Congress approved a retirement income credit for civil service annuitants equal to the lowest tax rate on $1,200. Eight years later that credit was advanced to $1,524.

We recommend that the committee incorporate into the current bill removal of income tax on civil service pensions. Should this not prove feasible under the circumstances, the council believes there should certainly be no reductions in the current retirement income credit.

ALEXANDRIA, VA., *December 5, 1963.*

Hon. HARRY F. BYRD,
The Committee on Finance, Senate Office Building,
Washington, D.C.

SIR: I appreciate the opportunity to submit material in writing on H.R. 8363 for the record.

If the public hearings should be extended or resumed in 1964, I should appreciate consideration of the advisability of my presenting an elaboration of this material in person. Discussions between the committee and the witnesses during the two sessions of these hearings which I have attended lead me to believe that I might be able to contribute some new and valuable points of view on questions involved in this bill and which obviously concern the members deeply.

In conclusion may I express my total disagreement with the editorial in this morning's Washington Post to the effect that the chairman and the committee have been obstructing and conducting a sit-in strike against the tax cut bill. It seems certain that almost none of the members of the public whom the editorial cites as calling for its quick passage have read the bill or could understand much of it if they did. I believe that both these hearings and all administration statements in support of the bill have barely scratched the surface of its features and its weaknesses.

Very truly yours,

GEORGE A. EDDY.

WRITTEN STATEMENT FOR THE SENATE FINANCE COMMITTEE HEARINGS ON H.R. 8363 DECEMBER 5, 1963

INTRODUCTION AND SUMMARY

This statement attempts to express in highly condensed form an independent economist's judgment on the probable economic consequences of the tax cut proposal now under consideration by this committee and to indicate ways of overcoming its weaknesses. It deals with a few broad economic principles rather than with details, important though the latter are. The particular point of view submitted herein has not been presented by other witnesses, so far as I know from attending two sessions and from inadequate reading of and about the testimony.

The advocates of this tax cut proposal, and especially the administration spokesmen, who have testified with what seems coordinated uniformity on the basic rationale, and also the chief critics of the proposal, are in my opinion making some serious mistakes of economics.

The advocates are proceeding on a faulty analysis of why we now have extensive unemployment, and they recommend a cure which has major chances of failing.

The critics, on the other hand, base their main position—the dangers of adding to the public debt and the efficacy of a balanced Federal budget and of a surplus—on a different misunderstanding and, if they should succeed in blocking the tax cut, would make little or no progress toward reducing unemployment.

To appreciably reduce unemployment without price inflation will require charting a different, still more unprecedented, and difficult course between the backers and the unqualified opponents of a tax cut.

For a tax cut to succeed in substantially increasing employment without price inflation, major rearrangements will be required in this country's policies and practices regarding—

1. Wage rates and other labor costs;
2. Settlement of our international payments deficits; and
3. Monetary and credit management.

On related economic grounds it would be highly desirable to reduce the total of Federal expenditures and taxation. No workable means has been suggested of financing a $100 billion budget without either, on the one hand, taxing annual earnings which are lower than what is widely recognized as indispensable for bare subsistence (the Federal income tax now starts at $600 per year for the individual, not to mention excise and sales taxes and other Federal taxes passed to the consumer), or on the other hand, taxing so much from higher incomes that a private enterprise system is genuinely impaired.

DISCUSSION

The administration's purposes in seeking this tax cut—reexpressed by President Johnson on December 4 as aiming to create 5 million more jobs (to a total of 75 million) and to wipe out poverty in this country—should be wholeheartedly endorsed and assisted, an under suitable circumstances, the Federal Government's spending borrowed money, within real limits, can play a most important and beneficial role.

Under present conditions, however, (and under those prevailing in this country since the Second World War and even back to about 1937), tax cuts financed by borrowing are, broadly speaking, unlikely to achieve a satisfactory increase in jobs without incurring a damaging rise of prices. The increased spending will, other things being equal, probably be nullified far short of the desired goal of reduced unemployment by two or three factors—wage rate and price increases, increased imports of foreign goods and services and increased export of U.S. capital, and restrictions of monetary and credit management.

Although administration spokesmen have mentioned these three problems, their assurances have seemed to me to be inadequately supported assertions and wishful thinking rather than incisive, thorough analysis. The economic specialists who have let their department heads and the President to believe that a big tax cut will lead virtually automatically, plainly, and simply, to a multimillion increase in employment and without price inflation seem guilty of injurious oversimplification and of giving inadequate attention to difficult unsolved problems.

The fact that these three inseparable considerations of H.R. 8363—prevailing practices regarding labor costs, international payments, and monetary management—are not now before this committee and largely come before other committees of the Senate, is a signal example confirming the recent statement of the Senate majority leader that, "Congress under the Constitution and its established procedures is not equipped to respond, to reach a decision one way or another, on urgent matters which go to the heart of our national economic structure."

If it seems of use to the committee, I should welcome the opportunity to elaborate upon these summary comments either in writing or in person and to offer concrete suggestions on what preferable course might be followed.

MEMORANDUM OF CHARLES W. DAVIS IN OPPOSITION TO USE OF DECEDENT'S BASIS IN COMPUTING GAIN ON PROPERTY ACQUIRED FROM A DECEDENT

GENERAL

The President's 1963 tax message proposed that a capital gains tax be imposed on all net gain accrued on capital assets at the time of transfer at death or by gift. The explanation given by the Secretary of the Treasury for this drastic change from existing law is that

"Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment choices and frequently results in complete immobility of investments of older persons." (Hearings, Committee on Ways and Means, President's 1963 tax message, p. 54, p. 49 of message.)

Before the House Ways and Means Committee, this proposal was modified to one requiring that the basis of property acquired from a decedent be that of the decedent, increased by the estate tax on the appreciation. Both of these suggestions are completely unjustifiable and ignore the fact that, when appreciated assets are transferred at death, the appreciation does not escape tax, but is subject to heavy estate taxation—at rates ranging up to 77 percent. To impose an additional capital gains tax on this same appreciation is to resort to double taxation of the most discriminatory type.

Fortunately, some of these considerations were recognized by the House Ways and Means Committee, and the present version of the bill, as passed by the House of Representatives, contains no change in existing law relating to property acquired from a decedent. However, there has been a suggestion that the proposal for a carryover basis will be revived before the Senate Finance Committee. Amendment No. 225 is intended to be proposed by Senator Gore to H.R. 8363 If it is offered, it should be rejected.

THE SYSTEM EMBODIED IN PRESENT LAW WAS ADOPTED ADVISEDLY AND IS NOT A LOOPHOLE

There is a laudable effort presently being exerted to close loopholes in the Internal Revenue Code. With this effort no one can quarrel. The difficulty lies in the misinterpretation sometimes put upon the term "loophole." A provision which is fair and which has been adopted advisedly by the Congress, with full knowledge of its workings and effect, is not a loophole, despite the fact that by changing it, additional revenue might be raised. The provision which establishes a date-of-death value (or alternate-valuation date value) as the basis of property acquired from a decedent is such a provision.

While there have been relatively minor shifts in congressional policy relating to the proper basis to be accorded property acquired through certain special types of transfer by decedents, there has been no congressional deviation from the principle that, in the normal case, any property owned by a decedent and transferred at death shall take a new basis. While the 1916 and 1918 Revenue Acts contained no specific provision relating to property acquired from a decedent, but had only a general provision that, in the case of property acquired subsequent to March 1, 1913, the basis should be the cost thereof, Treasury Regulations 45, art. 1562, issued under the 1918 act, provided:

"In the case of property acquired by gift, bequest, devise, or descent the basis for computing gain or loss on a sale is the fair market price or value of the property at the date of acquisition or as of March 1, 1913, if acquired prior thereto." These regulations accorded with the intent of Congress, and when a specific provision relating to property acquired by bequest, devise, or inheritance was added to the Revenue Act of 1921, it was noted that: "The special rules embodied in existing law with respect to property acquired by bequest, devise, or inheritance are in substance preserved" (H. Rept. 350, 67th Cong., 1st sess., p. 9).

Even at this early date, however, some persons who failed to analyze the relationship between the estate tax and the income tax were suggesting that this rule should be changed. On November 3, 1919, the Secretary of the Treasury submitted to the Ways and Means Committee a document entitled "Notes on the Revenue Act of 1918." This document represented a collection of suggestions for study and was submitted without recommendation by the Secretary, who stated that the Treasury would be opposed to some of the suggestions contained in it. The document contained the following:

"It has been suggested that, although transfers of property by gift, bequest, devise, or descent should not be treated as giving rise to realized gain or loss, whenever, thereafter, gain or loss is realized by actual sale, the gain or loss at that time should be measured as the difference between the price received and the cost to the original owner who acquired the property for value.

"It is urged in support of this suggestion that the effect of the present legislation is to permit realized gains due to appreciation taking place during the previous ownership to escape taxation" (pp. 10, 11).

With this suggestion before Congress, Dr. T. S. Adams, Tax Adviser to the Treasury Department, appeared before the Senate Finance Committee in executive hearings on the Revenue Act of 1921. Dr. Adams made two recommendations of interest here. First, he urged that property acquired by gift should take the donor's basis, as suggested in the foregoing notes. Second, contrary to the notes, he urged that property acquired by bequest, devise, or inheritance

should take as its basis its fair market value at the date of acquisition. His reasoning was given as follows:

"Senator McCumber. Whatever the child receives by inheritance or bequest it gets without cost or sale exactly the same as a gift. In the next paragraph you make a distinction.

"Dr. Adams. That is because the estate or inheritance tax has been imposed. That is the thought behind that" (executive hearings, Senate Finance Committee, Revenue Act of 1921, 67th Cong., 1st sess., p. 27).

And again, Dr. Adams testified:

"* * * Where it is acquired in that way it is subject to estate tax, and I think it is entirely fair and proper. That is the reason we give the value at the time of acquisition. Property acquired by bequest, devise, or inheritance is subject to the estate tax" (p. 198).

Congress accepted both of these recommendations, and section 202(a)(2) of the 1921 act provided a carryover basis in the case of property acquired by gift, while section 202(a)(3) provided that: "In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition." It will be noted that there was no gift tax in effect at this time, but that the Federal estate tax dates from 1916.

There were no substantial changes enacted thereafter until 1928. However, in 1926, the Court of Claims decided the *McKinney* case (62 Ct. Cl. 180), in which it held, under the 1918 act, that a decedent's executor had no "cost" and that the decedent's property in the hands of the executor took the decendent's basis. Congress at once indicated its belief that such a carryover of basis was improper. In the report of the Joint Committee on Internal Revenue Taxation (1927), volume 1, the following statements appear:

'Until recently gain or loss on executor's sale was measured by the value at the decedent's death of what was sold. As a result of the decision by the Court of Claims in *McKinney* v. *United States*, and the denial of certiorari by the U.S. Supreme Court, the rule was changed so as to provide that gain or loss on such a sale would be measured as though the decedent had sold the property during his life.

"The rule of the *McKinney* case is inconvenient, for it is often impossible to determine the decedent's cost or other basis. Moreover, as a practical matter, it results in taxing the value of bequests, devises, and inheritances as income. The old rule seems preferable, and it is recommended that it be set forth in the statute.

"Section 204(a)(5) prescribes the basis when the beneficiary sells the property as the value at the time of "acquisition." Some doubt has arisen as to what is meant by the date of acquisition. The "date-of-death" is recommended to make the basis certain and definite (p. 117).

* * * * * * *

"This rule is particularly desirable in view of the difficulty which may be encountered by executors and administrators in ascertaining what the decedent paid for the property, especially when it had been held by him over a long period of time.

"It may be argued that in a substantial sense the rule of the *McKinney* case results in taxing as income the value of property acquired by bequest, devise, or inheritance, a result which is contrary to specific provisions relating to gross income in practically all of the revenue acts. The rule above suggested preserves intact the full force of section 213(b)(3) of the Revenue Act of 1926 and similar parts of preceding acts" (pp. 74, 75).

The same position was taken by representatives of the Cleveland Chamber of Commerce, the Association of the Bar of the City of New York, the Committee of Banking Institutions on Taxation, and other witnesses who stressed the impractical, if not impossible, requirement of determining decedent's basis imposed upon the executor by the *McKinney* decision. (See hearings, House Ways and Means Committee, Revenue Act of 1928, 70th Cong., 1st sess.)

As a result of the foregoing report and testimony, the House of Representatives (in the 1928 bill) adopted a provision that date-of-death value was to be the basis of all property acquired by bequest, devise, or inheritance, or by a decedent's estate from a decedent. The latter phrase was intended to overturn the *McKinney* decision. In the Senate Finance Committee, the section was altered to provide two different rules. Date-of-death value was made the basis of property acquired by specific bequest, of real property acquired by general or

specific devise, or by intestacy, and of property acquired by a decedent's estate from a decedent. In all other cases, basis was made the fair market value of the property at the time of distribution to the taxpayer.

Thereafter, it became apparent that use of distribution date values permitted a certain amount of tax avoidance by executors who were also testamentary trustees and who could, by judicious selection of the date to effectuate distribution to themselves, control the basis of property in their hands as trustees. A subcommittee of the House Ways and Means Committee recommended that the provision be changed "so that a uniform basis rule may be required in the case of property passing at death, whether real or personal" (Hearings, House Ways and Means Committee, Revenue Act of 1934, 73d Cong., 2d sess., p. 136).

Roswell Magill, speaking for the Treasury Department, while questioning certain language changes recommended by the subcommittee, stated:

"* * * I take it that the subcommittee and the Treasury are in agreement as to what the basis should be in those cases. * * *

* * * * * * *

"The Treasury is in entire agreement with your purpose" (p. 145).

Mr. Colin F. Stam, of the staff of the Joint Committee on Internal Revenue Taxation, appearing before the Senate Finance Committee in executive hearings, was most explicit of the then Treasury Department position:

"* * * Under the present law, we use the value at the date of death for computing gain or loss, in most cases, but in the case of property passing as the result of a general or residuary bequest, the present law permits the person receiving the property to take, as the basis, not the value at the date of death, but the value at the date of distribution, which may be a good deal greater than the value at the date of death.

"For instance, when a man dies he may have a piece of property worth $100,000, taking the same illustration. By the time the executor distributes the property, it may be worth $500,000.

* * * * * * *

"* * * The man that receives this property really did not pay anything for it; and *we have gotten the tax up to the date of death through the estate tax*, when the value was $100,000. We have not gotten any tax on the increase in value up to the time of distribution, which was $500,000, and we just want to make it clear that we are going to take as the basis, both for gain or loss purposes, the value at the date of death" (Executive hearings, Senate Finance Committee, Revenue Act of 1934, 73d Cong., 2d sess., pp. 65–66; emphasis supplied).

From the enactment of the 1934 act to the present time, property acquired from a decedent has taken a new basis, either its value at the date of decedent's death, or, since 1942, its value on the alternate valuation date, where such alternate has been elected for estate tax purposes. Rather than restricting this well-established principle, in 1954 Congress extended it to cover, for the first time, all property included in a decedent's gross estate for Federal estate tax purposes. This final change clearly indicates a continuing congressional awareness that the Federal estate tax imposed upon appreciated assets eliminates any justification for the imposition of a capital gains tax upon the same appreciation. The reason given by the Senate Finance Committee for the extension of the date-of-death basis provisions in the 1954 code was simply that "Under existing law, there is no uniform correlation between section 113(a)(5) and section 811 of the 1939 code, relating to property includible in the decedent's gross estate" (S. Rept. 1622, 83d Cong., 2d sess., p. 423).

It should also be noted that while the concept that all property subjected to the Federal estate tax should take a date-of-death basis was not adopted until the enactment of the 1954 code, the majority report of the Special Tax Study Committee dated November 4, 1947, recommended that "The basis of property acquired by gift but included in the gross estate of the donor should be made the same as it would have been had it actually passed at death, if the property is sold after the donor's death" (Hearings, House Ways and Means Committee, 80th Cong., 1st sess., revenue revisions 1947–48, p. 3633).

The foregoing legislative consistence cannot be disregarded, especially in view of the fact that proposals similar to those rejected by the Ways and Means Committee in drafting the present bill, and amendment No. 225 intended to be proposed by Senator Gore to H.R. 8363, have been made periodically ever since the Notes on the Revenue Act of 1918, above referred to. When Congress was confronted with the emergency of the Nation's participation in World War II,

Randolph Paul, tax advisor to the Secretary of the Treasury, stated to the Ways and Means Committee:

"Under present provisions the basis for determining gain on an asset acquired from a decedent is the market value of such asset at the date of death. Appreciation in value in the hands of a decedent, thus becomes frozen in the basis accorded to the heir or legatee.

"A large part of the capital gains inherent in the increased value of property thus escapes income tax, as the assets are handed down from one generation to the other. To remove this special privilege, it is suggested that the basis of property to the recipient for the computation of capital gains and losses be the same as it was in the hands of the decedent" (Hearings, House Ways and Means Committee, 77th Cong., 2d sess., Revenue Act of 1942, pp. 89-90).

Despite the fact that this constituted a Treasury Department proposal, and despite the need for substantially increased revenues to support the war effort, the Ways and Means Committee wisely included no such provision in the bill reported by it to the House of Representatives and no such provision was in the bill passed by that body and sent to the Senate. The recommendation was not renewed before the Senate Finance Committee.

Thus, the principle that appreciated assets should be given a basis equal to the estate tax valuation in the hands of the person who has acquired them from a decedent is the result of considered congressional judgment over the past 42 years. Furthermore, such judgment has been exercised in the face of repeated arguments that such appreciation had "escaped income taxation." Such an established legislative policy should not now be reversed in the absence of compelling reasons to do so. Such reasons do not exist. Rather, the reasons which have traditionally supported the present law equally valid today.

A CARRYOVER BASIS IS NO MORE THAN A DISGUISED DRASTIC ESTATE TAX INCREASE, APPLIED UNEQUALLY TO ESTATES OF EQUAL SIZE

The impact of Federal estate taxation, with rates ranging up to 77 percent, is competely disregarded by the proponents of the carryover basis. Yet for anyone seriously concerned about "incentives" to encourage the flow of wealth into productive enterprises, the Federal estate tax stands as a serious obstacle. One of the prime motivating forces in American life is the desire on the part of taxpayers to enhance their wealth for the benefit of ensuing generations of their family. To the extent that the Federal estate tax renders this more difficult, this motivating drive to invest, to furnish risk capital in the hope of reaping a substantial gain, is lessened. Nevertheless, for policy reasons long accepted by Congress, the estate tax is a part of the American scene and it is not here suggested that it be repealed or the rates thereof reduced.

However, it must be recognized that the present proposal to establish a carryover basis in the case of property acquired from a decedent is, in reality a disguised increase in estate tax rates. Furthermore, it is an increase which affects only those estates the creator of which has most successfully invested his capital to produce an enhancement in his, and the Nation's, overall wealth. The enactment of the proposed amendment would place a premium upon liquidity, upon investments in safe, but nongrowth assets, such as bonds and insurance. This is not to say that such investments are unwise, or that they do not furnish capital for the growth of the Nation's business; it is to point out that such investments are a far cry from true risk capital.

Validity of the foregoing criticisms may be demonstrated by a comparison of four situations, each involving an estate of precisely the same size.

Case No. 1

Assume:

Taxable estate comprised entirely of life insurance and bonds with a market value of par	$5,060,000
Federal estate tax	2,468,200
Balance remaining after payment of taxes	2,591,800

This is the result under present law, it would be the result if a carryover basis provision were enacted into law.

Case No. 2

Taxable estate comprised entirely of stock with a basis of $506,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (455/5060×$2,468,200)	2,221,380
Add basis of stock	506,000
New basis of stock	2,727,380
Ratio of basis to value of stock (percent)	53.9
Ratio of gain to value of stock (percent)	46.1
If stock with a market value of $2,500,000 is sold to raise funds to pay the estate tax:	
Capital gain (0.461×$2,500,000)	$1,152,500
Capital gain tax at 21 percent	242,025
Add estate tax	2,468,200
Cash need	2,710,225
There is thus an additional cash requirement of $210,225. If an additional $235,000 of stock is sold:	
Capital gain (0.461×$235,000)	108,335
Capital gain tax at 21 percent	22,750
Total selling price	235,000
Less capital gain tax	22,750
Additional cash raised	212,250
Federal estate tax	2,468,200
Add capital gain tax on initial sale	242,025
Add capital gain tax on second sale	22,750
Total taxes	2,732,975
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,732,975
Balance remaining after payment of taxes	2,327,025

Thus, due to the need to sell appreciated assets to pay Federal estate tax, total taxes are increased $264,775, or 10.73 percent. The value of the assets remaining after payment of taxes is reduced 10.22 percent, and such assets have a basis of only 53.9 percent of their value, so that a substantial additional capital gain tax will become due if they are sold in the future.

Case No. 3

Taxable estate comprised of $1,000,000 insurance, $1,000,000 bonds valued at par, and stock with a basis of $306,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (2754/5060×$2,468,200)	1,343,343
Add basis of stock	306,000
New basis of stock	1,649,343
Ratio of basis to value of stock (percent)	53.9
Ratio of gain to value of stock (percent)	46.1
If stock with a market value of $500,000 is sold, with insurance and bonds, to pay estate tax:	
Capital gain (0.461×$500,000)	$230,500
Capital gain tax at 21 percent	48,405
Add estate tax	2,468,200
Cash need	2,516,605

Case No. 3—Continued

There is thus an additional cash requirement of $16,605. If an additional 20,000 of stock is sold:

Capital gain (0.461×$20,000)	9,220
Capital gain tax at 21 percent	1,936
Total selling price	20,000
Less capital gain tax	1,936
Additional cash raised	18,064
Federal estate tax	2,468,200
Add capital gain tax on initial sale	48,405
Add capital gain tax on second sale	1,936
Total taxes	2,518,541
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,518,541
Balance remaining after payment of taxes	2,541,459

In this case, by use of the nonappreciated assets to pay the bulk of the Federal estate tax, total taxes are increased only $50,341, or 2.02 percent, but the previously well-balanced estate is now entirely in stock. The stock, of course, has a basis of only 53.9 percent of its value, as in case 2.

Case No. 4

Taxable estate comprised entirely of stock with a basis of $506,000	$5,060,000
Federal estate tax	2,468,200
Estate tax on appreciation (4554/5060×$2,468,200)	2,221,380
Add basis of stock	506,000
New basis of stock	2,727,380
Ratio of basis to value of stock (percent)	53.9
Ratio of gain to value of stock (percent)	46.1

If, for business reasons it is necessary or desirable to sell all of the stock:

Capital gain (0.461×$5,060,000)	$2,332,660
Capital gain tax at 21 percent	489,859
Federal estate tax	2,468,200
Add capital gain tax	489,859
Total taxes	2,958,059
Taxable estate	5,060,000
Less Federal estate tax and capital gain tax	2,958,059
Balance remaining after payment of taxes	2,101,941

Here total taxes are increased $489,859, or 19.8 percent, an utterly unjustifiable increase, and total taxes are very much greater than would have been the case had the stock been sold immediately prior to death.

Capital gain ($5,060,000 less $506,000)	$4,554,000
Tax on gain at 21 percent	956,340
Taxable estate ($5,060,000 less $956,340)	4,103,660
Estate tax	1,863,400
Add capital gain tax	956,340
Total taxes	2,822,045
Total taxes if stock sold after death	2,958,059
Total taxes if stock sold before death	2,822,045
Difference	136,014

ORDERLY ADMINISTRATION OF ESTATES WILL BE SERIOUSLY JEOPARDIZED BY CARRYOVER BASIS

It is axiomatic that one of the first duties of a fiduciary administering the estate of a decedent is to plan to meet the necessary cash requirements. Under present law, this requires the fiduciary to ascertain the approximate date-of-death value of the decedent's estate. Using this figure as a guide, a relatively close approximation of administration expenses and death taxes can be made in a comparatively short time following the decedent's death. Debts can be ascertained, and, thus, cash requirements estimated. The prudent fiduciary begins at this point to raise the necessary cash. To wait until the alternate valuation date for the Federal estate tax has passed, or until the cash must actually be spent, is to gamble with trust funds. A serious decline in market values, leaving the fiduciary compelled to sell an excessive percentage of the decedent's estate might well subject the fiduciary to surcharge.

Now, however, assume that all assets formerly belonging to the decedent are held by the fiduciary with the decedent's basis, or with such basis increased by the amount of Federal estate tax attributable to any appreciation in value. In either case, before sales can be prudently made for the purpose of rasing cash needs, a determination of the decedent's basis for every asset must be made. Since the immediate sale of highly appreciated assets will greatly increase the estate's tax burden, as discussed above, good judgment requires that, where possible, those assets which have appreciated least be sold first. This fact produce two extremely undesirable results.

First, the desire to avoid incurring additional taxes may lead the fiduciary to sell the more stable, safer investments, and to retain the more speculative, those which have increased in value the most in the past, but which may decline the most in the event of a market decline. The sale of such stable assets, if there is a decline in remaining volatile assets, will assuredly be the subject of criticism, if not actual attack, by the beneficiaries of the estate. On the other hand, if the speculative assets are sold, and the stable investments retained, and there is no market decline, the unfortunate fiduciary is wrong again. He has incurred unnecessary tax expense, and the beneficiaries of the estate are equally disturbed.

Second, before any consideration can be given to which assets are to be sold, the basis of all assets in the estate must be known. Yet, where the assets have been acquired many years before, or have passed through several estates, always with a carryover basis (as would be the case in the future, if not in the first few years under the proposed new law), such determination will be extremely difficult, if not impossible. At the very least it will require a good deal of research by the fiduciary; research takes time. Until such time has been spent, sales will not be made, and the fiduciary will be unavoidably delayed in his imperative task of providing for the cash needs of the estate. Orderly estate administration will have been sacrificed on the altar of Federal taxation.

A CARRYOVER BASIS POSES SERIOUS PROBLEMS FOR ESTATE BENEFICIARIES

If specific assets acquired from a decedent are required to take as their basis the basis in the hands of the decedent, serious inequities can result among the beneficiaries of an estate. For example, if a father has two children, one daughter and one son, whom he desires to treat equally, he may find it impossible to do so. Assume a $2 million estate after payment of taxes, one-half consisting of stock in a closely held corporation in which the son is an active participant, one-half in bonds. Assume further that the stock has a basis of $200,000 and the bonds a basis of $1 million. Under present law, equal treatment of son and daughter is a simple matter of leaving the stock to the son, the bonds to the daughter. The son is given the business interest which he desires, the daughter is given a readily marketable security. However, if the son were to take the stock with a $200,000 basis, or even with a $200,000 basis increased by the estate tax on $1,800,000 of appreciation, he would receive an asset substantially less in realizable value than the daughter whose bonds would have no appreciation subject to tax on disposition.

On the other hand, if the stock and the bonds were each to receive a basis of $600,000 (one-half of the aggregate basis of the stock and the bonds), so that each asset was considered to contain potential capital gain of $400,000, the daughter would be seriously wronged. She would acquire $1 million of bonds which had cost her father $1 million. Such bonds would in no true sense

whatsoever have any capital appreciation inherent in them. Yet, upon their sale, a completely fictitious gain of $400,000 would be taxed to the daughter, although the decedent could have sold without gain. There is no constitutional justification for such a tax, which would surely be a capital levy. It would be as just and as constitutional to enact a statute providing that all assets acquired at death take a basis of zero, or $10, or $1,000, regardless of their cost to the decedent, as to arbitrarily reduce the basis of the bonds from $1 million to $600,000, and to transfer a portion of the bonds' cost to the stock, thereby increasing its basis from $200,000 to $600,000.

UNDER THE PROPOSAL APPRECIATION WOULD BE TAXED HIGHER IN SMALL ESTATES THAN IN LARGE ESTATES

Under a basis carryover provision which has been proposed, the same dollar amount of appreciation would bear a higher capital gain tax after passing through an estate of moderate size than it would after passing through a larger estate.

Assume three estates, each including a stock with a basis of $100,000 and appreciation of $900,000, with a date of death value of $1 million, with respective taxable estates of: A. $1 million; B. $5 million; C. $10 million. The stock in question is sold by the executor or heir.

A

Taxable estate		$1,000,000.00
Estate tax		303,500.00
Portion of estate tax attributable to appreciation (9/10 by 303,500)		273,150.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	273,150	
		373,150.00
Capital gain		626,850.00
Tax thereon at 21 percent		131,638.50

B

Taxable estate		$5,000,000.00
Estate tax		2,430,400.00
Portion of estate tax attributable to appreciation (9/50 by 2,430,400)		437,472.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	437,472	
		537,472.00
Captial gain		462,528.00
Tax thereon at 21 percent		97,130.88

C

Taxable estate		$10,000,000.00
Estate tax		6,042,600.00
Portion of estate tax attributable to appreciation (9/100 by 6,042,600)		543,834.00
Selling price		1,000,000.00
Basis:		
Original	$100,000	
Increase	543,834	
		643,834.00
Capital gain		356,166.00
Tax thereon at 21 percent		74,794.86

IN MANY INSTANCES THE EFFECT OF CARRYOVER BASIS COULD BE AVOIDED BY THE ASTUTE

One of the primary and most substantial criticisms leveled at the present Internal Revenue Code is that its complexity and, to be frank, its frequent departures from what might be termed "commonsense law," render it a trap for the unwary, while its more rigorous provisions can be avoided by those with astute tax counsel. So it is with the carryover basis provision.

Unless an average basis device is employed, a law requiring property acquired from a decedent to take the decedent's basis would work further hardships on some taxpayers while posing relatively little problem for others. For example, it would be a simple matter for a decedent possessing both appreciated and nonappreciated property to provide by will that the former pass to taxpayers in low tax brackets, while giving the latter to those in higher brackets. If a charitable bequest were involved, the appreciated property could be left to charity and the nonappreciated to the family. It would not even be necessary to specify the property to go to charity, if a general clause required satisfaction of the charitable bequest with the most appreciated assets. The tax results in such case would be the same as under present law. If the appreciated assets consisted of securities with a widespread market, and if the family felt that they would prefer to hold such securities rather than the assets left to them, they could sell their bequests of nonappreciated assets with relatively little capital gain and reinvest the proceeds in an open-market purchase of assets comparable to those left to the charity. Where such careful tax planning was not performed, however, the results for the family would be entirely different.

THE PRESENT DATE-OF-DEATH BASIS PROVISIONS ARE NOT ALWAYS BENEFICIAL TO TAXPAYERS

The Treasury support for the proposal to establish a carryover basis for assets acquired from a decedent and, without it, the Treasury opposition to a reduction in the capital gains tax rates and inclusion factor, were expressed in the testimony of Secretary Dillon before this committee, as follows:

"This reduction in the House bill to a 40-percent inclusion factor and the 21-percent limitation is unacceptable to the administration.

"It provides a rate reduction which will largely benefit our wealthier citizens without treating a concomitant problem of equity in capital gains taxation; namely, that gains which are unrealized at the time of death are never subject to income taxes" (hearings, Senate Finance Committee, Revenue Act of 1963, 88th Cong., 1st sess., p. 128).

As often is the case with recommendations advanced in the name of equity or the attainment of theoretical symmetry, the above statement fails to take into account that the present provisions establishing date-of-death value as the basis of property acquired from a decedent are not an unalloyed blessing. It is entirely possible that assets may decline, rather than appreciate in value before the death of their original owner. In such case, the basis of property received from a decedent is, nevertheless, its value at date of death, and the beneficiaries of the estate are precluded from thereafter claiming the benefits of a capital loss based on such decline. This is not a situation in the control of the original owner of the depreciated assets because the deductibility of capital losses is strictly limited and an unused capital loss carryover dies with the taxpayer. Thus, in a period of declining values the Treasury proposal for a carryover basis would have precisely the opposite effect from that now sought, i.e., it would permit beneficiaries of estates to take losses and reduce their taxable income in a period when tax revenues were already falling. It is an historical fact that many of the present tax-free exchange provisions of the Internal Revenue Code were enacted in the depression era when the Treasury was more concerned with eliminating the recognition of losses than in finding new ways to require gains to be recognized. To assume that this condition may not arise in the future is to be unduly optimistic, and to enact into law a provision which, with all of the faults discussed above, has only the virtue of increasing revenues in a period of rising prices would be most unwise.

CONCLUSION

It is submitted that the proposal for a carryover basis in the case of assets acquired from a decedent ignores the long legislative history of the present law, is unworkable and unjust, and adds a completely unnecessary complication to the Internal Revenue Code. Unrealized appreciation is not free of tax so long as the Federal estate tax contains rates ranging as high as 77 percent, and no present proposal exists to reduce such rates. The suggested legislation, to the contrary, is a disguised attempt to raise such tax rates in a discriminatory and unwise fashion. Appreciation over several generations would be subject to tax in the hands of the last owner, thereby subjecting him to the cumulative impact of inflation and a tax penalty which might make prohibitive a wise decision to dispose of the property. On the other hand, where there had been depreciation over a long period of time, the last owner of the property would be entitled to claim the income tax benefits of the decline in value which preceded his ownership although he in no wise had suffered the detriment thereof.

Enactment of the proposed carryover basis provisions would do far more than plug a nonexistent "loophole." It would distort income, penalize growth, and discriminate among taxpayers. In periods of depression, it would open tax avoidance avenues not now available. The proposal should be defeated.

STATEMENT OF JOHN H. ELSE ON BEHALF OF THE NATIONAL LUMBER & BUILDING MATERIAL DEALERS ASSOCIATION

My name is John Else and I am legislative counsel for the National Lumber & Building Material Dealers Association on whose behalf this statement is presented.

The retail lumber and building material dealers support a tax reduction if such reduction is accompanied by a reduction of Government expenditures and an effective effort to reduce the budget deficit.

For this reason we believe it reasonable for Congress to postpone final action on the tax bill until all appropriation bills for fiscal 1964 are approved and until the budget for 1965 is presented to the Congress.

A general tax rate reform measure would be more acceptable than H.R. 8363 but it does not appear that such a general reform bill will be considered in the foreseeable future.

We are fearful that unless a tax reduction bill is passed now, it may be several years before Congress again considers tax legislation.

Consequently, H.R. 8363 is preferable to no tax bill and is at least a start toward a permanent reduction of tax rates.

Equally important, however, is the reduction of Federal expenditures and the demonstration of fiscal responsibility by the President and the Congress.

The recent statement by the President concerning the budget for 1965 is encouraging and we applaud his effort to eliminate those programs which are unnecessary or which can be postponed.

Although some Members of Congress apparently think that reduction of Federal expenditures depends entirely upon the President, it seems that this an evasion of the issue because Congress, in the final analysis, holds the purse strings.

Recent action by Congress on some of the appropriation bills for fiscal 1964 would indicate that Congress is holding the line on current expenditures. This is an encouraging sign and we hope this will continue on the remaining appropriation bills.

H.R. 8363 places too much emphasis upon the need for increased consumer spending and not enough on the expansion of business facilities to create more jobs and to reduce unemployment.

Investment in productive facilities has been adversely affected and discouraged by our present tax rates. The greatest stimulus to the economy can be provided by a tax bill which will encourage expansion of facilities to provide more jobs.

Without burdening this committee with many of the detailed provisions of H.R. 8363, we would like to point out a few provisions approved by the House of Representatives which should be corrected in the Senate.

The bill imposes a fixed limit on group term insurance after which it becomes taxable to the employees.

Such a provision would discourage employers from setting up a group insurance program.

Furthermore, if this provision is approved it is, we fear, only a matter of time before the ceiling on such insurance is reduced or eliminated.

This provision should be deleted from the bill.

The bill would repeal the 4-percent dividend credit now permitted under the present law. The purpose of the credit was to lighten the burden of double taxation of corporate earnings and dividends. The original purpose of this provision was sound and we believe it should be retained.

We question the advisability of the provision in the bill directed against multiple surtax exemptions.

In many instances there are good and valid reasons for setting up separate corporations having common control.

To assume that such separate corporations were formed merely for preferential tax treatment is not being realistic.

These are but a few of the provisions of the lengthy tax bill.

We respectfully urge Congress to consider the tax reduction bill in the light of spending programs presented to Congress for fiscal 1965.

STATEMENT OF HON. FRED SCHWENGEL, MEMBER OF CONGRESS, FIRST DISTRICT OF IOWA

Mr. Chairman, I am grateful for this opportunity to submit a statement to this committee on this very important tax measure which it is now considering. I regret that the committee is unable to hear me personally.

Permit me to state for the record immediately, that I am not opposed to a tax cut as such. I am opposed to a tax cut if we do not cut expenditures and bring them in line with incoming revenue, if we do not accompany it with needed reform and revision. The idea of a planned deficit is alien to our American ideals. It violates the solid economic principles that have molded and preserved our great free enterprise system. A Presidential adviser came up to the Hill and told us that we needed to be reeducated, that the economic principles we have held so long are no longer valid. This is regrettable. What is needed is not reeducation, but restudy and a reconsideration of some economic facts of life and a need to take another look at our tax system. It needs revision, reform, and change. Involved in this is the cutting of taxes in certain brackets, the plugging of loopholes, and other revisions and reforms. This is all desirable but for one thing; our expenditures continue to rise. If we want a tax cut the accompanying revision in our tax structure, we must hold the line on expenditures. The thing I fear most from a tax cut and a spiraling budget is inflation.

Several years ago I made a series of speeches on inflation. My slogan then was "Hold the line in '59." Today I say, "Inflate no more in '64."

Permit me to quote from a book by W. H. Hutt. He says, "People are very slowly awakening to the truth that inflation is an act of Government and that it is almost always—in these days—the consequence of calculated, even if reluctant action."

All indications are that a serious attempt is being made now to keep expenditures down but the fact remains that the last 4 years Government spending has increased at the rate of $5 billion a year. Our public debt has increased on an average of $8.5 billion a year. The combined effect of an increase in Government spending and debt and tax cut would make available to the spending public an almost unexhaustible source of money to purchase goods and services. In the end the demand would be greater than the supply and the resulting increase in prices, the resulting inflation would be then directly attributable to Government action—cool, calculated, and action that we here seemingly are not reluctant to take.

I would like to go on to address myself to a proposal for revision in the tax code.

For many years I have been interested in the problem of financing higher education in this great country of ours. This interest of mine was kindled early when I worked my way through college, then for a short time taught school. My interest continued during the years I was advising families about their insurance needs as an insurance agent. Looking at the problem from all of these vantage points it has become clear to me that something must be done to ease the burden of those who must pay for a college education. The method I am advancing is a tax credit approach.

For 7 years now I have maintained a research team at the University of Iowa. Much of the effort of that team of law students has been directed toward the refining of my ideas about the finance problems of higher education. Several years ago the first legislative proposals were made. Since then they have been worked and reworked until now I believe that my plan, which I call "the Iowa Plan for Growth and Progress in Higher Education," is worthy of the consideration of this committee.

Let me explain the Iowa plan.

The Iowa plan is a tax credit proposal. Phase I of H.R. 22 would grant a tax credit of $50 a year for each educational certificate purchased from a local commercial bank, a savings and loan association, or a life insurance company doing business in at least three States.

One certificate a year could be purchased every year for each dependent from age 1 through 18, or graduation from high school, whichever comes first. This educational certificate would be purchased by the parent, guardian, or their written designee whether it be an individual or corporation. Only one certificate for each child could be purchased. The amount of the money paid for educational certificates would be deducted from the purchaser's income tax. For example, a man has three children and buys three certificates, costing him $150. His total income tax for that year is $600. He would then deduct the $150, the amount paid for educational certificates that year, from his total tax bill of $600 and pay the Federal Government $450.

These certificates can be used only by the student for the purpose of education in an approved institution of higher learning, and only if he maintains his grades. If a certificate is purchased every year from age 1 through 18 a fund of $900 would be invested in these educational certificates. When you add the interest to this you have a fund of $1,400. If, for any reason, the student does not enroll in a college within 4 years, or if he does not maintain his grades, the fund of that individual will revert to the Federal Treasury. If the student attends college this fund will be distributed over a 4-year period. The financial institution holding the funds from purchase of the educational certificates will treat this account as it would any savings account until the child enters college. It would then make payments directly to the particular college for application against tuition, fees, room and board, and so forth.

Phase II of the Iowa plan would grant a tax credit not exceeding $100 a year or the actual amount of educational expenses for a full-time student, whichever is less, to the taxpayer sustaining the major burden of educational expenses for that individual student. This credit then would apply to either the student, his parents, or guardian, or their designee in writing. The secretary would set up a scale of the amount of tax credit for part-time students.

The total amount of the tax credit an individual could receive applying to his college expenses with interest would be approximately $1,800.

Phase III of the Iowa plan is still in the research stage. Phase III involves the use of the revolving fund accruing from the purchase of educational certificates, an estimated fund of $20 billion. We are proposing that a State board of approximately 25 members representing the various interest groups of the State be set up. The professions, labor, business, finance, the State school board, junior colleges, public and private educational institutions, the board of regents, et cetera, would be represented. This board would be commissioned to keep on top of the educational problems of its particular State and recommend policies to be followed. It would also be empowered to grant loans to colleges for whatever purposes the individual college has a need, if it clearly demonstrates its need and ability to repay the loan. The board would also be permitted to make loans to individual students whose financial situation is such that the tax credit would be insufficient to insure his ability to attend college.

If a loan is approved by the board the central bank of the State would be directed to grant such a loan from the funds accruing from the purchase of educational certificates. The central bank would inform the individual financial institutions what percent of their deposits they should send to the central bank for such loan, based on an annual audit. Upon repayment of the loan to the central bank the financial institution would be repaid with interest.

I do not contend that the Iowa plan will mass produce brilliant scientists. I do not contend that the Iowa plan is a cureall for our educational ills. I do not contend that it will produce a new American man. But I do contend that it is a sound and fair proposal that would greatly enhance the opportunities our educational system offers without imposing bureaucratic controls on that system.

I do contend that it is a proposal consistent with the goals of democracy and freedom that our great Nation stands for. I do contend that if a potential scientist desires an education this plan will make it possible for him to have one irregardless of his wealth or social status. Finally, I contend that it will also permit a student interested in art, in poetry, in history—in the humanities in general—to attend colleges. I do not think we should forget this area. Of all the dangers of federally controlled higher education the encouragement of the gap between the sciences and humanities is certainly one of the most perilous.

The Iowa plan avoids the controversial church-state issue. A person who takes advantage of the $50 tax credit each year would be free to attend any accredited institution of higher learning.

There are other advantages of the Iowa plan. The plan would be a stabilizing factor in the economy. There will be $25 billion worth of these educational certificates in a very short time. This $25 billion will be in savings and loan accounts, regular savings accounts, insurance funds, and other accounts. These moneys can be used to enhance the business and industrial community. They can be used as the basis of loans, used for expansion purposes, and in many other ways can contribute to the economic growth of this country.

The Iowa plan is admittedly long range, but in an era where many programs appear to be only stopgap proposals, it seems to me that we should look to the future and plan for it effectively. The Iowa plan would encourage parents to plan ahead.

The Iowa plan would be an incentive for them to adequately prepare for their children's education.

One today cannot overstate the value of an education. The freedom to get an education where one chooses and how one chooses has been the foundation of this great Republic. The Iowa plan is a step toward insuring that this freedom will continue to live. The costs of higher education, constantly rising, are becoming increasing prohibitive. Young people, ready and willing to fulfill their quest for knowledge, are being denied an opportunity because of lack of funds. The Iowa plan will help these young people to fulfill their dreams, will insure the opportunity of many to get the kind and quality of education necessary for this country to maintain its position as a leader among nations.

I would like to comment on the amendment proposed by Senator Ribicoff and 12 other Senators, amendment No. 329.

This proposal is a tax credit approach to the problem of financing higher education. However, it limits itself to the problem of relief for those who bear the cost, paying expenses for an individual's college education. In this respect, as I see it, the proposal only goes halfway. Under the Iowa plan, much of the problem of financing construction of academic facilities would be solved through the use of the revolving fund set up by the purchase of the $50 certificate.

While I have reservations about the proposal advanced by Senator Ribicoff I do believe it is worthy of consideration and if enacted would be a step in the right direction.

I sincerely hope the committee will give serious consideration to the Iowa plan outlined in H.R. 22. The Iowa plan if enacted would solve completely the problem of Federal finance of higher education. Congress no longer would be faced with education bills each year.

I would like also to endorse S. 2068, the bill introduced by Senator Long and cosponsored by 19 other Senators, designed to clarify and simplify expense account deductions, at the same time preventing the abuses of the past which stemmed from the so-called Cohan rule. An identical bill, H.R. 8250, has been introduced in the House by Representative Hale Boggs.

Much of the strength of our country has been built on sales and sales promotion. Perhaps the most basic ingredient of a sale is goodwill between the salesman and prospect. This goodwill is built in many ways, among these the occasional or even frequent entertainment of the prospect.

Those of us in elective office also have to build goodwill, as we are, in a sense, salesmen. Just as a salesman entertains prospects from time to time, so too, do we entertain constituents. Sometimes our wives, many of whom are excellent vote getters, accompany us, when we entertain our constituents at a meal or otherwise.

There is nothing morally or legally wrong in the salesman's entertainment of the prospect, nor in our entertainment of the constituent. Indeed, in both cases it is an inescapable duty of the position held that we do these things, whether or not we are in a mood to do them.

S. 2068 would replace the present confusion with rational standards, and at the same time, by not reverting to the Cohan rule of estimation, would prevent many of the abuses of the past.

Those who are on expense accounts must be free to exercise business judgment in such expenditures. When such expenses are reasonably related to the furtherance of our business, they should be allowed as deductible items.

I urge the Senate Finance Committee to support S. 2068 when it is offered as an amendment to the tax bill.

I appreciate this opportunity to present my views to the Senate Finance Committee. I only wish that the circumstances would have allowed me to do it personally.

STATEMENT ON TAX MEASURES (H.R. 8363, AND SEVERAL AMENDMENTS THERETO) BY U.S. SENATOR HIRAM L. FONG OF HAWAII

Mr. Chairman and members of the committee, I appreciate very much this opportunity to express my views on H.R. 8363, the omnibus tax bill and several amendments thereto now pending before you.

A 300-page bill with countless amendments, H.R. 8363 comprises one of the most complex and difficult measures this Congress will handle. A very heavy burden devolves upon members of this committee to weigh and evaluate the extensive provisions approved by the House and the numerous alternatives and suggestions of the many witnesses who have already appeared before you.

The pros and cons of these matters have been amply set forth in your hearing record, and therefore I shall confine my statement to a general philosophical view of tax reductions and tax treatment of dividend income, plus some brief comments on several amendments which I have cosponsored.

I have long believed that Federal tax laws have been an obstacle to greater economic growth of our Nation. Income tax rates both on individuals and businesses have been too high too long. Other tax features have acted as a drag on economic expansion and job formation.

It seems to me as a general proposition that we need a two-pronged approach. Income taxes on individuals should be reduced so as to stimulate consumer buying.

At the same time, taxes on business should be lowered so that business can expand and new businesses will be formed. Other growth-inhibiting features of our tax laws should be modified also to spur the economy.

In these ways, more jobs will be created for our growing work force.

In deciding how much to reduce tax rates and what other tax changes to make, we must consider the total financial picture of the Federal Government. And that picture has been one of steadily rising expenditures resulting in multibillion-dollar deficits. The deficit forecast for the current fiscal year that ends June 30, 1964, is about $9.2 billion if the House tax bill goes into effect January 1, 1964.

To finance tax reductions when the Federal Government is so deeply in the red means Uncle Sam will have to borrow money to pay its bills. If America is to maintain the value of its currency and avoid the inflationary aspects of deficit financing, the upward Federal spending trend must be reversed.

Both Congress and the administration will have to exert strong efforts to stem the tide of unnecessary Federal spending to justify giving tax cuts of a size sufficient to stimulate the economy.

The combination of lower Federal spending and an economy stimulated by tax cuts would then work toward closing the dollar gap between Government income and Government outgo.

I shall not attempt in this statement to "second-guess" this committee on how low income tax rates can go, for the committee has the benefit of all the previous testimony and of technical financial data prepared by the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation. My only comment is that, while I was pleased that the lowest income group received the greatest reduction, under the House bill, I believe not enough reduction was granted middle income groups. I hope this committee will approve greater tax relief for middle income groups.

To decide what is fair and just considering the equities of millions of taxpayers and the needs of our Federal Treasury is a very, very difficult task. I appreciate the heavy burden falling on members of this committee. I am hopeful that tax reductions recommended by the committee will relieve undue hardship now in our tax laws and reduce taxes sufficiently to point the way toward economic progress and greater employment.

DIVIDEND EXCLUSION AND TAX CREDIT

I also hope this committee will look very carefully at the dividend tax provisions approved by the House.

The House rejected the administration's original proposal to repeal both the present $50 exclusion and 4-percent tax credit on dividend income.

Instead, the House raised the exclusion of dividend income to $100 ($200 if husband and wife each receive dividends) and reduced the 4-percent credit to 2 percent as of January 1, 1964, repealing it entirely as of January 1, 1965.

The Treasury Department states the House provisions would increase tax revenues by $300 million annually.

The Treasury Department further states that of the 6.2 million taxpayers who receive dividend income, 2.5 million would find their taxes increased under the House dividend provisions; 1.7 million taxpayers would not be affected as their dividend income is already excluded under the $50 exclusion; and only 2 million taxpayers would have their taxes reduced.

In other words, more taxpayers with dividend income would be hurt than helped by the House dividend provisions; 40 percent would be hurt, 27 percent would be unaffected, and only 32 percent helped.

This fact, plus the fact that investors will have to pay $300 million more in taxes, is directly contrary to the claimed purpose of the bill to stimulate investments in business and industry so as to create jobs.

I am concerned that the House provision may work particular hardship on elderly persons who rely on dividend income to provide for their daily needs.

I am also concerned that raising the exclusion to $100 and repealing the 4-percent tax credit may impose a hardship on modest income taxpayers receiving dividends. I call attention of the committee to page 913 of the printed hearings where it was testified that—

"The majority of the investors on the 2.5 million returns facing higher taxes are not high-income shareowners. Nearly 60 percent of them have adjusted gross income of less than $10,000. Indeed, a typical stockholder (with an average household income of $8,600) would pay 12 percent more tax on his dividends under the $100 exclusion proposal than with a 4-percent credit and $50 exclusion."

I strongly urge this committee to revise the dividend tax provisions so as to remove the hardship on the elderly and those of modest income and so as to encourage, not discourage, capital investment in American business and industry.

AMENDMENT NO. 338 TO H.R. 8363, REAL PROPERTY TAX DEDUCTION FOR LESSEES

I strongly urge that the committee give favorable consideration to my amendment, No. 338, to H.R. 8363. This amendment is identical to S. 344, a bill introduced earlier this year by me with the cosponsorship of Senator Inouye.

It would amend the Internal Revenue Code of 1954 to permit an individual who leases land and uses that land as the site for his residence to deduct real property taxes paid by him which are assessed against such land if the real property taxes must be paid by the lessee under the terms of the lease agreement. The lease must also be for a period of 20 years or more.

Under present provisions of the Internal Revenue Code, real property taxes are allowed as deductions to the taxpayer only if the tax is owned and paid by him.

Land in Hawaii is scarce. There are large tracts of land in Hawaii which have been subdivided and leased out as residential districts for periods in excess of 20 years. In many of the lease contracts, the lessees are required to pay all real property taxes. In such instances, because the lessor owes the tax but the lessee is required to pay it, neither party is permitted to claim the payment as a deduction on his Federal income tax return.

My amendment would correct this inequity and allow the lessee who is legally obligated to pay the real property taxes assessed against his leased land and does pay it to claim such payments as tax deductions.

This would also apply to sublessees if their leases met the requirements applicable to prime lessees: that is(if the land is used as his residence, the lease agreement covers a period of 20 or more years, and the sublessee is required to pay the real property taxes on such property.

AMENDMENT NO. 229 TO H.R. 8363, ENTERTAINMENT EXPENSE TAX

I strongly urge favorable consideration of the amendment offered by the junior Senator from Louisiana (Mr. Long) to modify the tax provisions adopted last year disallowing certain entertainment expenses. This amendment is identical to S. 2068, which I am privileged to cosponsor with Senator Long and other Senators.

There is no question that last year's act has badly hurt many employees and industries dependent upon the spending of money by businessmen for business-related travel and entertainment expenses. The proposed amendment is directed toward creating stability in these industries while at the same time providing needed protection against abuses.

I certainly do not believe the American taxpayers should pick up the tab for parties, vacations, lodges, yachts, and other entertainment for the personal benefit of businessmen.

On the other hand, some travel and entertainment expenses directly related to business should be allowable as business costs. As representative of a State where tourism is our largest income-producing industry next to agriculture, I am keenly conscious of the importance of business conventions and travel to large numbers of employees, hotels, transportation, restaurant, and associated industries. Therefore, I urge the committee to approve this amendment as a stimulus to the tourist and related industries in America.

AMENDMENT NO. 336, RAPID WRITEOFF OF WASTE TREATMENT FACILITIES

I strongly urge the committee to approve this amendment which would allow businesses and individuals who install air and water pollution control facilities to deduct the entire cost in any 1 of 5 years after purchase, rather than over the useful life of such facilities as at present.

As members of this committee recall, the Senate recently passed two important pollution control bills, one relating to water and one to air. It was my privilege to cosponsor both these bills as reported by the Public Works Committee, of which I am a member.

At the time the Public Works Committee considered these measures, we were very conscious that success of pollution control hinges greatly on installation by business and industry of special equipment and facilities, which may be very costly. To encourage business and industry to install such facilities promptly, I believe a faster writeoff of costs than now permitted would be a key factor in combating pollution of the air we breathe and the water we use. Healthful air and healthful, usable water are a public necessity as Congress has recognized in previous air and water pollution laws and as the Senate this year reaffirmed. Therefore, it is in the interest of public health and safety to speed the installation of antipolluting devices through our Nation's tax laws.

It is significant to note that the form of tax relief proposed has been recommended by the 1960 National Conference on Water Pollution, the Advisory Commission on Intergovernmental Relations, and the Federal Water Pollution Control Advisory Board. The official policy statement of the National Association of Manufacturers "urges provision for sufficient income tax deductions to offset the cost of such non-revenue-producing facilities within a 5-year period, if desired, rather than over the useful life of the facilities." Just recently this proposal was endorsed by the Manufacturing Chemists Association and earlier in the year by a representative of the National Canners Association.

AMENDMENTS PROVIDING TAX RELIEF IN CASE OF COLLEGE EXPENSES

Some 20 bills are pending before this committee providing deductions for certain expenses incurred in obtaining or providing higher education.

As one who strongly believes in greater opportunities for more young persons to obtain higher education, I urge this committee to approve some measure of tax relief for basic expenses incurred by parents sending their children to college or by students who are working their way through college.

The most striking paradox of our time is that there are jobs available all over America; yet there are more than 4 million persons without jobs. One of the major reasons is that many of these persons simply do not possess the skills required by these vacant jobs. In the future, more and more jobs will require higher skills than today. Our young people must receive training to qualify

for these jobs. It is in the public interest, through our tax laws, to encourage and enable more young people to receive advanced education beyond high school. I strongly urge this committee to include in H.R. 8363 tax incentive for college training.

In conclusion, may I again express my deep appreciation for this opportunity to comment on the very important tax and revenue measure this committee is considering.

I am awaiting your recommendations with much interest; and hope that after due and deliberate consideration by this committee and by the Senate, a tax reduction and reform measure will become law as soon as possible in the coming year.

Thank you.

STATEMENT OF THE PROPRIETARY ASSOCIATION ON THE REVENUE BILL OF 1963 (H.R. 8363)

This statement presents the views of the Tax Committee of the Proprietary Association on certain sections of the revenue bill of 1963. The Proprietary Association is a national trade organization comprised of over 100 member companies—small, medium, and large—representing a gross volume of business in excess of $1 billion a year. The membership is composed primarily of manufacturers of trademarked drugs sold over the counter without the necessity of a prescription.

This presentation is limited to the following sections of H.R. 8363:

Section 122. Current tax payments by corporations.
Section 201. Dividends received by individuals.
Section 202. Amendment of investment credit provisions.
Section 203. Group-term life insurance purchased for employees.
Section 212. Moving expenses.
Section 214. Employee stock options and purchase plans.
Section 215. Interest on certain deferred payments.
Section 219. Capital gains and losses.
Section 220. Gain from dispositions of certain depreciable realty.
Section 222. Repeal of additional 2-percent tax for corporations filing consolidated returns.
Section 223. Reduction of surtax exemption in case of certain controlled corporations, etc.

Section 122. Current tax payments by corporations

We believe that enactment of this section would be in direct conflict with the main purpose of the bill. The revitalization of the economy which it is hoped a tax reduction would provide, should take priority over fiscal manipulations for budgetary purposes. The bill should be strengthened by making every effort to obtain the maximum benefit from rate reduction without a dilution in the form of accelerated payments.

In addition, unlike individuals, most corporations must use the accrual system of accounting. Under this method, there is a time lag between the accrual of income based on sales and its realization as cash. This proposal to accelerate estimated payments would require the payment of taxes on income prior to its realization as cash and would necessitate borrowing by many corporations.

Section 201. Dividends received by individuals

We are opposed to the adoption of these provisions primarily because they bring us closer to complete double taxation. In addition, it seems inappropriate for a capitalistic country to discourage capital investment in securities.

Section 202. Investment credit provisions

We are in agreement with the stated purposes of this section and in favor of its enactment in its present form.

Section 203. Group-term life insurance purchased for employees

We are opposed to the enactment of this section as it would impose severe administrative problems on the employer, while the income taxable to an individual employee would be "de minimus." The additional machine accounting or bookkeeping required to include the taxable amounts in gross income and withhold tax thereon would be burdensome and sufficiently costly to substantially offset the expected revenue gains. If the major reason for enactment of

this legislation is a purported abuse of, or inconsistency in, present regulations, then, at least those group life plans which are formulated upon an annual salary multiple basis without discrimination among employee groups should be exempt from its provisions.

Section 212. Moving expenses

We are in favor of this section which would equalize the tax treatment of moving expenses of both new and old employees whether reimbursed or not. However, it is suggested that the term "moving expenses" be defined to include indirect moving expenses such as connecting appliances, and travel and other expenses relating to the acquisition and/or sales of residences.

Section 214. Employee stock options and purchase plans

We wish to comment as follows on this section:

Effective date, June 11, 1963.—The new provisions generally are effective for options granted after June 11, 1963. We recommend that amendments to the present restricted stock option provisions should be made effective on a prospective rather than a retroactive basis. Otherwise, the stock options granted after June 11, 1963, and prior to enactment will, in most instances, fail to meet the new requirements with the consequential adverse effect upon the employees. As an alternative, it is suggested that a period of time be allowed for conforming any options issued subsequent to June 11, 1963, to the new requirements.

Exercise of option within 5 years.—Considering the corrective measures taken in the bill, there appears to be no valid reason why the period of exercise need be shortened from 10 to 5 years. Many plans now provide for a waiting period between the date of grant and exercise and permit only a partial exercise over a period of time which frequently exceeds 5 years. This is an effective management tool, commonly used to induce an employee to continue his employment over a long period of time. The reason given for cutting in half the period that options may be outstanding, is that over 10 years, options will appreciate much more in value. Accordingly, the grant of such options is more closely associated with compensation and less toward the individual efforts of the employee. Furthermore, it has been stated that the purpose of the provision is to encourage the acquisition of a proprietary interest as quickly as possible. These are rather specious reasons for shortening the period. Moreover it may have just the opposite of the desired effect. An employee who has acquired shares through exercise would be inclined to sell in a market decline; one working under an option would endeavor to reverse the trend. Accordingly, it is suggested that the 10-year period be retained.

Order of exercise of options.—The requirement that options be exercised on a first-in first-out basis is inequitable and unrealistic. It imposes no hardship on an employer whose stock is gradually appreciating in value, but makes the stock option device an ineffective tool for retaining needed executives "locked in" because of a declining market or because they hold options granted at an unusually high peak.

Three-year holding period.—It is recommended that the holding period be measured from the date of exercise of the option shares by the employee rather than the date of transfer of shares. This would conform to the October 26, 1962, decision of the Court of Appeals, 8th Circuit (George W. S. Swenson, 309 Fed. (2d) 627), which held that the holding period for stock acquired upon exercise of an option commenced on the day on which it was exercised. Adoption of this principle would avoid possible adverse criticism of the employer as well as economic loss to an employee resulting from unavoidable delay in issuing the shares and to make the holding period uniform for all optionees.

Continuous employment.—The new act requires continuous employment during the period from the date of grant to the date 3 months prior to exercise, although it is indicated that, for this purpose, military leave or sick leave would not disqualify an individual. It would appear that the provision requiring the exercise of an option within 3 months of cessation of employment is adequate to cover this contingency. Therefore, the continuous employment rule appears unnecessary. As a matter of fact, it automatically makes ineligible for stock purchase plans employees whose customary employment is for more than 5 months but less than 12 months in any calendar year. Under section 423(b)(4)(C) these employees would otherwise be eligible.

Section 215. Interest on certain deferred payments

We recommend the rejection of this provision for the following reasons:

1. This provision introduces new and unnecessary complications into the tax law, difficult for many to understand, and burdensome to all to whom it may apply. We believe the Internal Revenue Code is unduly complicated as it presently exists. To add a provision such as this, which imputes income and corresponding deduction elements not intended by the parties to the transaction, and where the result on revenues would be negligible, is unwarranted.

2. There is also the possible danger that future examining revenue agents will apply this section so broadly as to encompass many normal business transactions not originally envisioned as subject to this section.

Section 219. Capital gains and losses

Under this section we wish to comment only on part (a)(3) dealing with certain distributions under employees' trusts and annuity plans.

There is no question as to the important position in the economy which pension and profit-sharing plans have assumed. We feel that this exclusion is an unwarranted discrimination against those persons whose savings are invested in a pension trust and denies them the benefits of tax reduction provided in this section. It is true that there are other exceptions to the general provisions of section 219, but this one stands apart from the rest.

The reduction of capital gains rates applicable to a pension trust distribution would be beneficial to the main purpose of tax reduction in that it would release additional funds to stimulate the economy.

Section 220. Gain from disposition of certain depreciable realty

We can agree to the provisions of this section only if legislative action is taken to extend the depreciation reform now available for machinery and equipment to the buildings housing this same machinery and equipment.

Section 222. Repeal of additional 2-percent tax for corporation filing consolidated returns

and

Section 223. Reduction of surtax exemption in case of certain controlled corporations, etc.

We are in favor of these sections but we believe that sufficient consideration has not been given to those corporations which are members of an affiliated group and which, for compelling business reasons, cannot practically file a consolidated return and which cannot benefit from the election to claim multiple surtax exemptions. Such corporations are placed at a serious disadvantage when compared to the position of other corporate taxpayers.

An affiliated group for which the filing of a consolidated return is practical is not taxed on dividends received from other members of the group. Corporate members of an affiliated group which elect to claim multiple surtax exemptions are subject to a tax on intercorporate dividends received from other corporations in the same affiliated group, but they are able to benefit from the continued use of multiple surtax exemptions. The affiliated group for which it is impractical to file a consolidated return and which cannot benefit from the multiple surtax exemption will suffer the twin disadvantages of being limited to one surtax exemption and still being subject to the tax on intercorporate dividends received from affiliated corporations.

In addition, there are serious, unnecessary, and unfair disadvantages which may be suffered by an affiliated group which is compelled to file a consolidated return to avoid the intercorporate dividends tax. They include the following:

(1) State tax problems and disputes;

(2) Costly and inconvenient changes in accounting methods and perhaps in fiscal years; and

(3) Various restrictions on limitations such as for foreign tax credits and charitable contributions.

It is respectfully submitted, therefore, that H.R. 8363 should include an amendment to section 243 of the code permitting a 100-percent deduction for intercorporate dividends paid within an affiliated group so as to make intercorporate dividends paid within the group tax free whether or not a consolidated return is filed. This amendment will result in no significant loss of revenue to the Treasury, and no increased tax avoidance possibilities will be afforded. The

proposed amendment will eliminate the forced filing of consolidated returns for the sole purpose of escaping the intercorporate dividends tax and thus result in considerably reduced administrative and accounting burdens to both taxpayers and the Government.

STATEMENT OF IRA H. NUNN, WASHINGTON COUNSEL, NATIONAL RESTAURANT ASSOCIATION, ON AMENDMENT 229, A PROPOSAL TO INCLUDE S. 2068 IN H.R. 8363, THE REVENUE ACT OF 1963

My name is Ira H. Nunn, and I am Washington counsel of the National Restaurant Association. The National Restaurant Association is a national association representing the restaurant and food-service industry.

The National Restaurant Association endorses any legislation which would ease the impact restrictions on travel and entertainment expenses, adopted by Congress last year in the Revenue Act of 1962, have had on restaurant industry sales. We believe the present expense account law is extremely complex and confusing to the American taxpayer. The uncertainty resulting from this confusing, complex law has caused honest but cautious taxpayers to forgo legitimate activity which would normally be beneficial to business. We believe the curtailment of legitimate, reasonable expense-account spending rather than the curtailment of expense-account abuses has seriously depressed a segment of restaurant industry sales. This decline in industry sales has resulted in substantial unemployment in the restaurant industry.

I would like to comment briefly on the effects the 1962 Revenue Act has had on restaurant industry sales and employment, and the need for new legislation such as is contained in amendment 229, a proposal to amend H.R. 8363 by including therein the provisions of S. 2068 (a bill introduced by Senator Long, Democrat, of Louisiana, as well as 19 other Senators including Senators Carlson, Curtis, McCarthy, and Ribicoff of this committee).

THE EFFECTS OF THE EXPENSE ACCOUNT LAW ON THE RESTAURANT INDUSTRY

A survey by the National Restaurant Association of over 500 known expense-account restaurants indicates an average sales decline of 14 percent for the first 4 months of 1963 as compared with the first 4 months of 1962. The National Restaurant Association estimates that this means an industry sales loss of approximately $1 billion annually. A sales decline of this magnitude will result in a job loss of approximately 140,000 if the trend continues throughout 1963. A survey conducted during November 1963 indicates that this trend has not changed significantly, although sales conditions have improved in certain areas throughout the country.

THE FALLACY OF USING CENSUS SALES DATA TO DETERMINE EFFECTS OF EXPENSE ACCOUNT LAW

The Treasury Department has attempted to refute to Congress and the public the fact that our industry has suffered serious sales losses because of the new expense account restrictions. Over the last several months, the Treaury Department has cited statistics published by the U.S. Bureau of the Census to demonstrate that the restaurant industry has not been hurt by the new expense account law. We would like to point out the fallacy of using census statistics for eating and drinking places to assess the impact of the expense account law on sales and employment in our industry.

In line with the general rise of retail stores, gross national product, and population, the total eating-and-drinking market has grown roughly 5 or 6 percent in sales in 1963 over comparable periods in 1962. Since curtailed food and beverage entertaining by businessmen of approximately $1 billion would only cause the total eating and drinking category to drop less than 3 percent, it might be assumed that a loss of sales and jobs would not result in the restaurant industry during a generally rising economy. I am sure, however, that the Senate Finance Committee can appreciate the fallacy of such an assumption. Hot dog, custard, and refreshment stands; cafeterias; lunchrooms; counter service; factory workers' feeding places; drive-ins; and the like rather than table-service restaurants with relatively high-priced menus, make up the vast majority of the census eating and drinking category. These establishments have not yet been hit by the repressive expense account law. Unfortunately,

the impact has been confined generally to table-service restaurants and to hotel, motel, and club dining rooms with relatively high priced menus. Thus, restaurants needlessly suffering sales loss and the employees losing their jobs derive little solace from the fact that the gross national product or retail sales generally are improving.

Moreover, in view of the Nation's chronic unemployment problem, we believe that the U.S. Senate should be disturbed about a needless job loss of 140,000 employees in the restaurant industry. We would expect this concern to exist even though some new jobs are being created in other types of eating places as a result of the generally rising economy. We would expect this concern to exist not only on humanitarian grounds, but on practical grounds as well. What does it profit the tax arm of our Government to collect an estimated $100 million from the present expense account law if it is to cost the taxpayers more than it produces? Lost income taxes from wages destroyed from this law alone will amount to more than $50 million. Add to this at least $126 million that must be paid by taxpayers in unemployment benefits.

WHAT IS WRONG WITH THE PRESENT EXPENSE ACCOUNT LAW?

The present expense account law is simply too complex for any normal taxpayer to understand, too irrational for any reasonable man to respect. A brief review of the history of this law and the legislative maneuvering surrounding it should shed some light on the causes for this uncertainty and confusion surrounding the present law.

In 1961, the Treasury Department proposed to the House Ways and Means Committee legislation which would disallow the tax deductibility of all entertainment expenses with one material exception, that is the so-called busines meal exception. This proposal, if it had been enacted, would in our opinion have been unjust and unnecessary; but at least it would have been readily understood by the taxpayer. The House Ways and Means Committee fortunately rejected this proposal of the Treasury Department and instead required that entertainment expenses to be deductible must be "directly related to the active conduct of the taxpayer's trade or business." The new so-called directly related test seemed to be virtually identical to the "ordinary and necessary" test already contained in the law. Courts had used the very same words when interpreting the law's requirement that all business expenses must be ordinary and necessary. Thus, the new standard for determining the deductibility of business entertainment expenses initially seemed to be very liberal indeed. The Ways and Means Committee report, however, reversed this initial impression of liberality. This committee report illogically interpreted the directly related test so as to prohibit for all practical purposes the deductibility of all business entertainment expenses which were not otherwise deductible under the "business meal" exception. The report's restrictive interpretation of the committee's new expense account standards was not consistent throughout, however; for the report was liberal where the statute was restrictive when concerned with the business meal exception. The report took a very liberal view toward the so-called business meal exception, clearly stretching the legislative language so as to permit deductibility of good will entertainment expenses.

Such liberality was clearly inconsistent with the statutory language of the business meal exception. When the bill reached the Senate Finance Committee, the inconsistency between statutory language and the Ways and Means Committee report was recognized by this committee. To offset the very restrictive view on the directly related test evident in the Ways and Means Committee report, the Senate Finance Committee adopted a new standard for determining the deductibility for business entertainment expenses. Under the Senate Finance Committee proposal, entertainment expenses would be deductible if they were "associated with the active conduct of the taxpayer's trade or business." The authors of the Senate Finance Committee report apparently found it somewhat difficult to make a distinction between the committee's new "associated with" standard and the xisting "ordinary and necessary" standard for determining the deductibility of any business expense. But a change from existing law on expense account spending apparently was politically necessary because of highly publicized so-called expenses account abuses. These changes were added in the Senate Finance Commitee report. Otherwise they might have never been known.

During the conference between the House and the Senate, a new test was added. The "associated with" test would only apply in instances where the entertainment "directly preceded or followed substantial and bona fide business discussion" including business conventions. The restrictions adopted by virtue of the Senate Finance Committee's report were somewhat liberalized, however, by the conference report. The report liberalized the Senate committee's interpretation of the "associated with" test and liberalized the "business meal" exception in some respects.

The law passed and was signed by the President; and in December, the Treasury Department issued its first series of regulations. The first regulations on recordkeeping were almost universally regarded as an extremely harsh interpretation of this part of the new law. Apparently because of the adverse public and congressional reaction, the initially proposed recordkeeping regulations were substantially modified by the Treasury Department and considerably improved, although there still remains much to be desired with respect to them. The Treasury Department then publicized the harshness of the substantive aspect of the new expense account law. The most damaging statement publicized was that the new law prohibited virtually all good will entertainment with a few exceptions. The effect of the extensive publicity given to the new expense account law was catastrophic on restaurant industry sales. Apparently public and congressional reaction generally was also adverse to the substantive interpretation made by the Treasury Department initially. At any rate, the Treasury Department reversed itself. Commencing in January 1963, Treasury took a very liberal view toward the new expense account law. When final regulations were issued on the substantive provisions of the new expense account law, the liberality of the Treasury Department was evident in many places. The restrictions on combined business-pleasure trips were virtually repealed by the Treasury Department's liberal interpretation. The Treasury Department resolved the inconsistencies contained in the legislative history with respect to the deductibility of wives' entertainment expenses by construing wives to be obviously business associates. A liberal interpretation was made of the so-called business meal exception. The vagueness of the law, the lack of any clear standard for determining the deductibility of business entertainment expenses, the several inconsistencies contained in the legislative history of the new law, the many and varied new tests for determining deductibility of entertainment expenses, the many and varied exceptions to the new test—all made the law capable of virtually any kind of interpretation.

In our opinion, the law as it is presently interpreted does not seem to distinguish reasonable, legitimate business entertainment expenses from expense account abuses. Rather, it sets up totally unresonable, artificial standards of conduct which, to the American taxpayer, simply do not make sense. The essence of the new expense account restrictions seems to be that a businessman must discuss business if he entertains in a place where he would not ordinarily discuss business (the "directly related" test). However, if he entertains in a place where he can readily discuss business, he does not have to discuss business (the "business meal" exception). In the latter case, however, only people with whom the taxpayer would discuss business may be present; otherwise, the taxpayer must discuss business (IRS regulations). Wives with whom the taxpayer would ordinarily have no business to discuss, for purposes of the new regulations, will be regarded as persons with whom businessmen would ordinarily be expected to discuss business (IRS regulations). It is also permissible, as we understand the new law, for businessmen to entertain in a place where ordinarily business would not be discussed without even discussing business if these bulnessmen have a substantial and bona fide business discussion immediately before or after the entertainment (the "associated with" test directly preceding or following substantial and bona fide business discussion). Finally, in the case of a convention, it is not necessary for the taxpayer to be present while he has this substantial and bona fide business discussion (conference report). Frankly, we believe all these sort of unreasonable standards make it difficult to eliminate through any regulation or IRS education program the confusion of the taxpayer.

Let me give you an example of some of the harmful effects of such unreasonable standards: A well-known restaurant in New York, Bill Reed's Little Club, recently sent a notice to its patrons that it was discontinuing all dancing so that the club would have an atmosphere conducive to business discussion. This meant a loss of work for several American taxpayers. It has been suggested

that maybe the Treasury Department should now provide Mr. Reed with a sign that would read as follows: "This establishment is now certified quiet enough for business discussion. Therefore, it is no longer necessary for businessmen to discuss business while they entertain their clients here." This might help Mr. Reed in encouraging continued patronage, but it is of little solace to the discharged musicians. These unemployed men might well ask why, if it is not necessary for businessmen patrons to discuss business when entertaining at the Little Club, they cannot have their jobs back.

There is considerable evidence of the basic confusion surrounding the new expense account law. The Internal Revenue Service is having perhaps the greatest difficulty with the complexities of the new law; so much so, that this agency has had to begin a special training program to teach its 14,000 revenue agents the ins and outs of travel and entertainment deductions. If the Internal Revenue Service must train its own agents in the complexities of the new rules, how can the millions of taxpayers who have to live under the new law understand it? The law is so complicated the Internal Revenue Service has found it necessary to issue innumerable press releases, make speeches, conduct educational programs, and publish extensive questions and answers in an effort to explain to the business community the new expense account restrictions. For the first time in history, the Internal Revenue Service has found it necessary, in order to promote a better understanding of the law, to publish interpretational aids (namely "Questions and Answers") regarding the new expense account law. Many taxpayers are uncertain about the continued deductibility of business banquets. Although this may seem a rather minor aspect of the new restrictions on business entertainment, it is by no means of minor importance to the restaurant industry. Prior to the adoption of the new restrictions on expense account spending, the restaurant industry derived several hundred million dollars in sales from business banquets. This was perhaps the hardest hit area of sales in our industry. Under the new law, such expenses are clearly deductible, although obviously many taxpayers are unaware of it.

The business community simply cannot understand why a reasonable, bona fide expense for good will entertaining has to be preceded by a business discussion and why it is necessary to discuss business at a time when business ordinarily would not be discussed while it is unnecessary to discuss business in an environment where business discussion is possible. Such standards do not create respect for the law. This normal lack of respect for the artificial standards necessary to justify business entertaining expenses leads to disrespect for the law. It only can leave the businessman with the conclusion that Government is attempting to harass him. Few rational men will willingly submit to an arbitrary, irrational law. Thus, if the situation continues, we believe it will seriously undermine the self-assessment tax system prevalent in this country. For this reason alone we believe there is sufficient justification for a clarification of the expense account restrictions adopted by Congress last year.

The November 8, 1963, edition of the Kiplinger Washington Letter contains an item regarding taxpayer's complaints about revenue agents. It states that taxpayers complain agents do not follow law or regulations or are ignorant of them. The claim is made that agents tend to be extra tough. One of the most frequently complained about areas is the area of travel and entertainment expenses. We believe that the confusion surrounding the new law coupled with the fear of unwarranted harrassment of the business community by revenue agents will lead honest but overly cautious businessmen to forgo perfectly legitimate activity which would benefit business and is legally deductible even under this complex, illogical law.

S. 2068—A SENSIBLE SOLUTION

S. 2068, if enacted, would repeal the artificial restrictions contained in the 1962 Revenue Act respecting the deductibility of business entertainment expense. In lieu thereof, S. 2068 would introduce a new workable standard of reasonableness for determining the deductibility of travel and entertainment expenses. This new standard would be tougher than the old standard of "ordinary and necessary."

The standard of reasonableness is not a novel standard for the Internal Revenue Code. To prevent the avoidance of corporate income taxes, the code prohibits the deductibility of unreasonable salaries by corporate taxpayers. To prevent the avoidance of personal income taxes due on dividends, the code prohibits the retention of corporate income beyond the reasonable needs of the

corporate taxpayer. These standards of reasonableness work. They are standards above and beyond the "ordinary and necessary" concept. They permit the tax collector to question the business wisdom of the expense. They permit the Government to prevent the avoidance of taxes by unwarranted business spending. Such a standard would work with respect to expense account spending. The enactment of S. 2068 would not mean a significant relaxation of existing law, but it would be a far better law—one that would eliminate the confusion and the complexity of the many and varied tests for determining the deductibility of business entertainment expenses. In essence, S. 2068 would leave intact the repeal of the so-called *Cohan* rule contained in the Revenue Act of 1962. Taxpayers would still be required to keep accurate records of business travel and entertainment expenses in order to deduct them. In our opinion a standard of reasonableness for determining the deductibility of business travel and entertainment expenses together with the record keeping required under present law would curtail, if not virtually eliminate, expense account abuses without undermining the self-assessment tax system.

The reasonableness of any business entertainment expense depends upon the facts and circumstances surrounding the particular case and not on the noise volume of the room in which the entertainment takes place. Abuses are possible under the present law just as they were under the previous law. Unfortunately, however, the present law militates against the interest of the honest but cautious taxpayer. The law is a law of confusion, a law of fear; and unfortunately not a just law. We believe that a new law is essential to create respect for the law. We believe whatever expense account abuses were prevalent in previous years have been substantially curtailed and will continue to be curtailed. Automatic data processing will militate against expense account abuses, especially in view of the new recordkeeping regulations. The addition of several new Internal Revenue agents, the fear created by extensive publicity of expense account crackdown, and a new standard of reasonableness should be sufficient to stop expens account abuses even after the repeal of the present virtually incomprehensible law.

CONCLUSION

In conclusion, we, therefore, recommend earnestly that the Senate Finance Committee amend H.R. 8363 by including therein the provisions of S. 2068. We believe the entire Congress recognizes the errors of the law passed last year and, thus, will accept such an amendment.

GENERAL ELECTRIC CO.,
New York, N.Y., December 4, 1963.

Hon. HARRY F. BRYD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: As your committee nears the end of its public hearings and approaches its executive deliberations concerning H.R. 8363, I should like to take advantage of the invitation extended by one of your distinguished colleagues to record briefly my personal views concerning the tax proposals under consideration.

There can be no disagreement with the administration's objective of fostering a more prosperous economy by loosening the constraints which the present Federal tax system imposes on our private enterprise system. Effective revision of our tax structure, especially the income tax rate structure, is long overdue and the need for it is, in my opinion, so pressing that a way must be found to accomplish it without, of course, abdicating our responsibilities to preserve fiscal integrity, an aim which you have labored so long and so effectively to achieve.

The most glaring defects in the present income tax rate structure are the high marginal rates, both individual and corporate, and the extreme progression in the individual rate structure. It is frequentely said that our present scale of individual rates, or something very close to it, was instituted at the beginning of World War II, and this is, of course, true. It is often overlooked in this connection, however, that the fast rise in rates got its start beginning in 1932 and continuing throughout the 1930's when the rates were scaled to range from 4 percent to as high as 79 percent.

As a businessman I am familiar with compensation plans and incentive devices that provide benefits commensurate with effort and achievement. I, therefore, find it difficult to understand a tax system which works in the opposite direction, which says to a man "the harder you work, the less you keep." I suppose the answers lies in the fact that our rate structure was adopted not for economic but for social purposes. The damaging effects of such a system are now, fortunately, so widely recognized that for the first time in 3 decades there appears to be an opportunity to reverse what only a year or two ago was called a "thus far irreversible error in tax policy."

The administration deserves much credit for recognizing the tax problem and proposing to do something about it. Perhaps a parallel can be seen in the recent action on depreciation allowances. Until last year depreciation allowances for tax purposes had been determined under a policy established in 1934 which had the effect of inhibiting expansion and modernization rather than contributing to economic growth. In 1962 the administration promulgated the new depreciation guidelines, which represented a bold, imaginative step in dealing with this problem. Your distinguished colleague, Senator Hartke, has introduced a bill, S. 2231, which would give legislative authority to this administrative reform and would take the further desirable step of removing the so-called reserve ratio test. I would hope that this proposal may have the favorable consideration of your committee.

The point, however, that I started to make was that just as the economic fallacy of a longstanding depreciation policy has been recognized and a significant step taken to change that policy, so it may be hoped, now that the damaging effects on our economy of the present rate structure have been recognized, that prompt action will be taken to improve the structure.

In much of the recent discussion on tax action, emphasis has been, understandably, on whether we can afford a tax cut in the light of the current budgetary situation. Passing this specific question for a moment, I think it is unfortunate that there tends to be lost in this kind of discussion the question of what kind of a tax cut should be enacted. I see the need for a tax cut not in terms of combating or warding off a recession, not in terms of a "shot in the arm" to stimulate the economy, but in terms of a long-needed, long-range reform of the rate structure to improve incentives, encourage effort and risktaking, accelerate capital formation, and contribute to our rate of economic growth, not for the benefit of a fortunate few but in the interest of the prosperity of all the people.

I regard this goal as so important that the present opportunity must not be lost. It is true that we are faced with an apparent dilemma with regard to our level of expenditures, but if we are ever to realize our national potential, a start must be made now—a way must be found.

The stated objectives of the bill before you are unexceptionable. The tax structure which it would provide would, on balance, I believe, be preferable to the present tax structure. It is unfortunate, however, that it does not deal more adequately with what I have outlined as the major problems.

Although rates would be reduced, the steepness of progression would actually be increased, a fact which has been so well documented before your committee that it need not be demonstrated again. The top rate would still be 70 percent, substantially higher than can be justified on grounds of fairness or sound economics. Moreover, this rate would apply at $100,000 of income, as compared with $200,000 under the present schedule. Reductions in tax liabilities, considering proposed structural changes as well as rate changes, would be substantially greater at the lower income levels than at higher levels of income. The proposed changes are heavily oriented toward increased consumer purchasing power, which does not markedly need bolstering, rather than toward increased capital formation which could speed our rate of economic growth. The bill as a whole, therefore, places the tax-reduction dollars where they are likely to do the least good for the economy in the long run and at the same time the kind of tax reduction proposed is the most expensive kind, giving rise to the budgetary problem with which you are so rightly concerned.

I am not going to propose a specific rate schedule, but I would hope that, as far as individual rates are concerned, your committee will find a way to reduce the progression through the middle brackets and, if a top rate as high as 70 percent must be retained, consider adding more brackets at the top and having this rate apply at a higher rather than at the presently proposed lower level.

As regards the corporate rate, a reduction from 52 to 48 percent is a change in the right direction but a very small step when compared with the pre-Korean

rate of 38 percent and when considered in conjunction with the proposed corporation tax payment speedup. I would suggest that an initial reduction of at least 5 percentage points be considered and that, thereafter, the rate be further reduced by 1 or 2 points a year until a predetermined level has been reached.

The 4-percent dividend credit would be repealed under the bill now before you. This credit is but a token recognition of the fact that corporation income is taxed twice, and the credit should certainly be retained and preferably enlarged. It has been objected that the dividend credit benefits chiefly the higher income individual. While this in itself is debatable, it is clear that relief from double taxation has to apply at the point where double taxation exists. This is another case where the national interest would be served by grounding tax policy in sound economics rather than social theory.

I naturally am deeply concerned that we achieve a balanced budget at the earliest possible date. While tax rate reform of the right kind can accelerate our rate of economic growth, enlarge the income base, and increase tax revenues, this process may require a considerable period of time to become fully effective. Pending achievement of maximum economic effect, we can anticipate that a tax cut of even the most beneficial sort will entail a net revenue loss. Since we are already in a deficit position, consideration of the question of reducing taxes clearly demands the most responsible judgment that can be brought to bear upon it.

Reform of the tax structure is urgently needed. It follows that strict control and, where possible, reduction of Government expenditures are also urgently needed. Statements of intention to restrain Government spending, such as those contained in President Kennedy's letter of August 19, 1963, to Chairman Mills of the Ways and Means Committee, Chairman Mill's release of September 16, 1963, and section 1 of the House bill, are welcome as expressions of recognition of the problem and the intention in good faith to deal with it. In the light of the almost uninterrupted climb in Federal spending in recent years, however, I believe that we should subject ourselves as a nation to a firmer discipline in expenditure control than that provided by a statement of intention.

The suggestion which you have made in your capacity as chairman of the Joint Committee on Reduction of Nonessential Federal Expenditures that unexpended appropriation balances of $87 billion be examined to determine which of them can be rescinded deserves the fullest investigation. I would also like to suggest that section 1 of the House bill be strengthened by adding some kind of a definite commitment to its laudable expression of intent. I do not at present have a specific suggestion as to the form which such commitment should take. One suggestion was narrowly defeated in the House. There must be another formula which would find general acceptance and I urge your committee to assume the leadership in seeking this out.

Sincerely,

G. L. PHILLIPPE, *President.*

STATEMENT BY WILLIAM A. QUINLAN, GENERAL COUNSEL, ASSOCIATED RETAIL BAKERS OF AMERICA

The Associated Retail Bakers of America is the national nonprofit trade association of retail bakers, who produce bakery foods for sale directly to the consumer across the counter of their own neighborhood stores.

We have been engaged since 1956 in a more or less continuing study of the tax problem of retail bakeries and other small- and medium-size businesses, including conferences with representatives of many other industries, and this statement is made in the light of that study and consideration.

We respectfully urge enactment as promptly as possible of the tax bill H.R. 8363 as passed by the House, especially for the following reasons:

(a) *Reduction of individual rates.*—The bill would, over a 2-year period, reduce individual income tax rates to a minimum of 14 percent and maximum of 70 percent (instead of the present 20 to 91 percent), and thereby relief to unincorporated businessmen as well as wage earners.

This would help consumers and all business by increasing consumer purchasing power, and in addition help to meet the serious need of smaller businesses, most of which are unincorporated, for more reinvestment of earnings in modernization and growth.

Businesses must have capital for modernization and growth if the economy is to prosper. Long-term capital, either equity or debt, is generally not available in the financial markets to small- or medium-size businesses, including those of retail bakers. Larger firms usually fill these needs through a combination of retained earnings and issuance of new securities. Smaller concerns must rely to a far greater extent, or entirely, on retained earnings to supply their growth capital requirements.

That being so, it has become apparent that the present high Federal taxes fall most heavily on smaller businesses, although they fall heavily on all.

It is apparent also that any meaningful tax relief program to help private enterprise and employment must help all legal forms of business, including corporations, individual proprietorships, and partnerships.

The great majority of small businesses, and this is true of retail bakeries, are unincorporated, so that the individual income tax rates, rather than the corporation rates, are the matter of importance from their point of view.

The proposed reduction in individual rates therefore is a step in the right direction.

(b) *Reversal and reduction of corporation rates.*—The bill would help smaller corporations especially by reducing the corporation tax rate to 22 percent—instead of the present 30 percent—on the first $25,000 of taxable income, and, over a 2-year period, help all corporations by reducing the total rate on taxable income over $25,000 to 48 percent—instead of the present 52 percent.

This would help to start providing desirable relief and stimulation for private enterprise and employment through incorporated businesses of all sizes—and to provide some significant immediate relief for smaller corporations, which most need more retained earnings for modernization and growth, through the annual tax saving of as much as $2,000 for any corporation having taxable income of $25,000 or more.

(c) *Correction of defect in reinvestment credit provisions.*—The bill would repeal the present provision that the amount of any allowable income tax credit for investment in depreciable assets must be subtracted from their value for depreciation purposes, and restore, for purposes of future depreciation allowances, any such amounts already subtracted.

The reinvestment tax credit enacted last year was an important step in the right direction for both unincorporated and incorporated enterprises. However, the provision in the present statute that the amount of any allowable income tax for investment in depreciable assets must be deducted from the value of the assets for depreciation purposes violates the principle of the credit, which should be a separate and added incentive for business modernization and growth, rather than a more rapid depreciation allowance. The bill would correct this error.

(d) *Rejection of death tax on capital gains.*—The bill would omit the objectionable income taxation, earlier proposed, of capital gains, between time of acquisition and time of death, on assets of decedents' estates, or between time of acquisition and time of a gift of assets.

This proposal, omitted from the bill as passed by the House, would have added heavily to the tendency of the income and estate tax burden to force sale or liquidation of smaller businesses, either before or after death of their owners, and therefore to the tendency toward monopoly.

At present, assets of an estate, including an unincorporated business or stock in a corporation, are subject to the estate tax on a basis of value at time of death. The proposal which was rejected by the House Committee on Ways and Means would, in addition, levy an income tax on as much as 30 percent of any gain in value from the time the assets were first acquired—perhaps many years before, as in the case of one who started a small business and devoted much of his lifetime to developing it into a successful concern worth many times the original value. It would be a severe penalty for success achieved through hard work and honest effort. And it would mean triple taxation—taxation of income reinvested in the business, taxation of the gain in value, and taxation of the current value as part of an estate or as a gift.

The present situation is already bad enough. Although the present provision for extended payment of the estate tax has been of some help, the burden of this tax, like that of the income tax, still tends to force sale or merger of small businesses after or in anticipation of death of their owners. The present $60,000 exemption is antiquated, and we respectfully suggest that it be double, but that this be done in a separate bill so as to cause no delay in enactment of H.R. 8363 as passed by the House.

(e) *Rejection of disallowance of personal deductions.*—The bill would omit the objectionable disallowance, earlier proposed, of religious and charitable contributions, taxes, interest paid, and other itemized personal deductions from taxable income, except to the extent that they would be, in the aggregate, over and above 5 percent of the taxpayer's gross income.

This proposal, which was rejected and omitted from the bill as passed by the House, would be unfair to those making such contributions or having such expenses, and would result in less support of worthy causes.

It is unsound in principle, because a deduction should either be allowed or not; disallowance of legitimate deductions should not take the place of tax rate changes. The proposal would be a move in the direction of taxation of gross income.

(f) *Rejection of repeal of corporation dividend exclusion.*—The bill would omit the objectionable repeal, earlier proposed, of the corporation dividend exclusion, and instead double the present amounts of exclusion of dividends from taxable income.

As the committee well knows, double taxation of corporation earnings—taxing first the corporation, and then the stockholder when he receives dividends—has long been criticized.

The bill is good to the extent that it retains and increases the corporation dividend exclusion, although it is bad in its reduction of the corporation dividend credit from 4 to 2 percent the first year and repeal of this credit thereafter. In the interest of expediting enactment of the bill as passed by the House, we suggest that restoration of the corporation dividend credit be considered as a separate issue in a separate bill.

(g) *Reduction of Government spending.*—The bill would declare it to be the sense of Congress that "revenue increases [resulting from the bill's stimulation of the economy] should first be used to eliminate the deficits in the administrative budgets and then to reduce the public dept," and that "to further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective."

We believe that tax relief is urgent, and should not wait for enactment at the same time of so-called tax reforms or structural changes in the revenue provisions.

On the other hand, we believe that the need for a determined and immediate start on a continuing program of drastic reduction in Government spending, so as to bring the budget into balance at the earliest possible time, is of vital importance. The key to solution of Government fiscal problems is a drastic reduction in Government spending, rather than so-called reforms in details of taxation.

An immediate start on relieving the stifling burden of taxation also is imperative, and we agree that conditioning such relief upon some arbitrary legal formula as to budget or spending could be self-defeating. In view of the assurances from the Congress, the late President John F. Kennedy and President Lyndon B. Johnson, as to reductions in cost of Government, we believe that the House-passed bill should be enacted speedily and without change, although urging the members of your committee and all Members of Congress and the administration to do all you can to reflect the strong public demand, in our industry and elsewhere, for drastic reductions in that cost.

There are two other provisions in the bill which are objectionable to retail bakers; that is, the disallowance of personal deductions for miscellaneous State or local taxes (other than real and personal property taxes, income taxes, and general sales and use taxes, all of which still would be deductible), and the disallowance of personal deductions for casualty and theft losses below $100 each. Again, however, we suggest that these be considered as a separate issue and corrected in a separate bill, in the interest of avoiding delay in enactment of H.R. 8363 as passed by the House.

The following resolution, which was directed by our board of directors to Chairman Wilbur Mills of the House Committee on Ways and Means prior to action by the House on the bill, still is relevant and is submitted also for your consideration:

"*Be it resolved by the Board of Directors of the Associated Retail Bakers of America, meeting at Chicago, Ill., on September 23, 1963,* That this association urges prompt enactment by the House and the Senate of the tax bill, H.R. 8363, as reported by the Committee on Way sand Means. The bill means an

opportunity, which may not come again, of providing vital relief for both smaller and larger businesses, unincorporated or incorporated, from the present stifling burden of Federal taxation, along with relief for employees and consumers, and stimulation of the economy which will benefit the Nation as a whole. The bill is not perfect in all respects for the retail baker, but it is basically sound, and avoidance of delay which could prevent final action this year is important. We respectfully emphasize also that a determined and immediate start on a continuing program of drastic reduction in Government spending is essential, and we welcome the declarations and assurances in this regard from your committee and the President, and urge passage of the bill in trust and confidence that they will be fulfilled."

The Associated Retail Bakers of America is mindful of the vital importance and responsibility of the work being done by your committee, and we wish you well in what we know to be a complex and difficult task.

Statement on Behalf of the National Association of Manufacturers

TAXATION OF GROUP-TERM LIFE INSURANCE

H.R. 8363 would require an employee to pay tax with respect to group-term life insurance under a policy "carried directly or indirectly by his employer" to the extent that his protection exceeds $30,000. This would be a departure from treatment followed consistently since 1920. Instead of serving the objective of tax equity, such taxation would open up a new area of discrimination in the tax law.

Under this bill, the amount to be includible in income for tax purposes would be the cost of insurance in excess of $30,000, less all sums paid by the employee toward his entire group insurance protection.

The nature of group-term life insurance

Group-term life insurance is the means by which the financial hazard of death is pooled for all members of a covered group. Policies written to cover employees of a firm or other establishment are based on the assumption of continuity in employment relation, from the time of becoming a member of the covered group until death or retirement. Thus, while the premium for the coverage is based on the average life expectancy of the group, the cost for an individual employee who becomes a member of the group before middle age and remains a member until retirement will average out on an equitable basis.

One of the misconceptions, however, applying to group-term life insurance is that, as of a given year, it benefits only the older as compared with the younger members of a group. This notion overlooks the insurability factor. Because participation is based on employment relation, younger as well as older employees who are poor insurance risks individually receive the greatest benefit from group protection. Regardless of when the employment relation begins, it is the poor insurance risk who often has no alternative to the protection of group-term life insurance.

The most important facet of group-term life insurance is not who pays the premium, the employer or the employees, but the fact that it reflects a continuous pooling of risks. This factor apparently was overlooked in the Treasury's recommendation to tax to the employee the value of employer-financed group-term life insurance above a given figure, as indicated by the statement in the Ways and Means Committee report as follows:

"The provision of this insurance by the employer relieves the employee of substantial costs of providing his own insurance protection for his family which he would otherwise have to provide out of taxpaid dollars."

The alternate to employer-financed group-term life insurance is not, as this quotation implies, the purchase of insurance by the individual.

The alternate is employee-financed group-term life insurance.

As will be shown subsequently in this statement, the drive of the Treasury to tax the individual under employer-financed plans in relation to what it would cost to provide his own insurance would, under the House bill, produce the unintended result of taxing older employees who pay the entire cost of their coverage under their group plan.

Uniform 5-year age bracket table

The cost of group life insurance protection under H.R. 8363 would be measured by the use of a uniform 5-year age bracket table in which the cost increases with age, or by the actual cost where the actual cost is determined by individual ages or 5-year age brackets. Because actual cost determination by ages or age brackets is inconsistent with the basic concept of group-term life insurance, its inclusion as an optional base for determination of income for tax purposes may be disregarded.

The use of a uniform age bracket table would emasculate the purpose of group-term life insurance. The burden of tax thereunder would largely fall on people from 50 to 65 years of age. Compared with the 40 to 44 age bracket under the 5-year bracket table, the cost for the 50 to 54 age bracket would approximately double, then triple for the 55 to 59 group, and quintuple for the 60 to 64 group—while not affecting employees in lower age groups who in some cases are much poorer insurance risks. Such snowballing of cost as a person moves into middle age and toward retirement is conceptually incompatible with the use of group-term life insurance as a protective pool based on continuity in employment relation without regard to age or the hazard of death for the individual.

Taxation of group-term life insurance on this base would, for the affected taxpayers, aggravate the injuistice of the steep climb of graduated rates through the middle and higher tax brackets.

Unintended results

While the intention in the House bill apparently is to provide offsets for employee contributions, the use of an age bracket table will create taxable income in some cases in which the participating employees pay the entire cost of such coverage. This may be illustrated for an employee age 56 who pays a $7 per $1,000 average premium for $70,000 of group-term life insurance, as follows:

Portion of insurance coverage taken into account ($70,000 minus $30,000)	$40,000.00
Cost of insurance protection per $1,000 for individual age 56 using 5-year age bracket table	16.29
Cost above $30,000 (16.29 times 40)	651.60
Actual employee contribution (7 times 70)	490.00
Amount to be included in tax base by employee ($651.60 minus $490)	161.60

If the employee in the illustration were age 60, the addition to his tax base would be $496.80 instead of $161.60.

There is no precedent in the tax law for such inequitable treatment. The only basis for such taxes would be the assumption that the employee had received compensation from his employer—but, his employer had not paid a single penny toward the cost of this coverage. Certainly, the Congress could not intentionally legislate on the basis of an assumption completely contrary to the fact.

Moreover, it is not necessary for employees to bear the entire cost in order to produce what apparently would be an unintended result under H.R. 8363. Specifically, take the case of an employee with $60,000 of coverage, in regard to which his employer pays half and he pays half of the $7 per $1,000 average premium. The logical assumption would be that this situation would produce no taxable income to the employee. This would not be so, as indicated by the following illustration of an employee age 60:

Portion of insurance coverage taken into account ($60,000 minus $30,000)	$30,000.00
Cost of insurance protection per $1,000 for individual age 60 using 5-year age bracket table	24.67
Cost above $30,000 ($24.67 times 30)	740.10
Actual employee contribution (60 times $3.50)	210.00
Amount to be included in tax base by employee ($740.10 minus $210)	530.10

It would seem totally unfair to confront an employee in this position with such an addition to his tax base.

What is the purpose?

The purpose of the Treasury recommendation and the House bill provision cannot be to establish equity in tax treatment because equity must rest on principle and not on dollar differentiation—$30,000 or higher.

That the purpose is not to raise revenue is indicated by the estimate of revenue pickup of only $5 million. It is a safe assumption that the administrative burden on the Government, and the compliance burden on the taxpayers, would involve a larger sum of money.

If the purpose is to establish a foothold for the taxation of nonmonetary income, all the implications in all areas should be thoroughly explored before deciding whether to proceed on such a course of action in light of all the equities and practicalities.

Recommendation

We, therefore, most strongly recommend that the provision requiring employees to pay tax on group-term life insurance in excess of $30,000 be stricken from H.R. 8363.

Large policies

The principal argument used by the administration in support of its recommendations is that large amounts of insurance are provided to certain executives. The fact that the amount of group insurance coverage furnished to an employee is large does not necessarily mean it is unreasonable or that it constitutes an abuse where it is provided under a group insurance plan which is nondiscriminatory by classes of employees, i.e., under which all employees in a given class are treated uniformly. Most group insurance plans provide coverage on a nondiscriminatory basis to all employees based upon earnings, service, classification, etc. If insurance coverage of $30,000 is considered reasonable for an employee with a salary of $15,000 per year (or even $10,000 or below), it follows that $100,000 of insurance coverage should likewise be considered reasonable for an employee with an annual salary of $50,000.

The fact that group life insurance coverage is ordinarily provided on a nondiscriminatory basis acts as an effective limit on the amount of coverage. We believe it would be most unfair to impose an arbitrary dollar limit on the amount of tax-free group-term life insurance without regard to the relation of insurance above that level to an employee's salary. If it should be decided to retain in H.R. 8363 some provision for taxation of group-term insurance, we believe the most reasonable approach would be to place a limitation on some multiple of earnings—at least two times annual earnings—in addition to the $30,000 exclusion.

Single average premium method

Moreover, if some provision is to be retained in H.R. 8363, it will be necessary to abandon the concept of age bracket tables if emasculation of the purpose of group-term life insurance is to be avoided.

The group concept of term life insurance involves the assumption of a continuing employment relation until retirement or death. Where the employer pays all or part of the cost, such employer contribution is spread over the total amount of group-term life insurance coverage to all participants in the employer's plan to arrive at the employer contribution per $1,000 of coverage. If tax is to be applied, the employer contribution per $1,000 of coverage should be the only statutory base for use by all employees regardless of age in determining the amount to be includible in taxable income.

The application of the single average premium method for determining cost of group-term life insurance protection where the employer pays all or part of the cost may be illustrated by the following examples:

Example 1.—The employer pays a monthly premium for each covered employee in the amount of 70 cents per $1,000 of coverage regardless of age. No contribution is made by any of the employees. Under the single average premium method, each employee regardless of age would be considered as having received from his employer 70 cents per month for each $1,000 of group life insurance coverage furnished by his employer.

Example 2.—The facts are the same as in example 1, except that each employee pays a monthly premium of 50 cents per $1,000 of coverage with the employer paying the remaining 20 cents. Under the single average premium method, each employee would be considered as having received from his employer 20 cents per month for each $1,000 of group life insurance coverage furnished by his employer.

Within the concept of group-term life insurance, the economic benefit to the employee is the amount which he is relieved from paying for his coverage by virtue of his employer's contribution. Thus, if group-term life insurance is to

be made taxable in regard to any amounts of coverage, the basis of tax should be the single average premium method, i.e., income measured by the amount of insurance premium actually paid by the employer because this is the amount which the employee would have had to pay if the plan had been solely employee financed.

SUMMARY

1. The provision for taxation of group-term life insurance included in H.R. 8363 would reverse law which has been in effect for 42 years; would create a new area of discrimination and inequity in the tax law; would provide only negligible revenue pickup probably more than offset by the administrative and compliance burdens on the Government and the taxpayers; and hence should be deleted from the bill.

2. If deletion, however, is not agreed to:

(*a*) The exclusion from taxation should be $30,000, or some multiple of earnings, whichever is higher.

(*b*) The cost of group-term life insurance protection should be determined by use of the single average premium method.

APPLICATION OF INTERCORPORATE DIVIDEND TAX TO MEMBERS OF AFFILIATED GROUP

Sections 222 and 223 of H.R. 8363 deal with the filing of consolidated tax returns and with multiple corporate surtax exemptions. In brief, they would accomplish the following:

1. Eliminate the tax benefit of multiple corporation surtax exemptions where two or more corporations are members of a controlled group or, on election, permit the claiming of multiple surtax exemptions, but with the imposition of a 6-percent penalty rate on the first $25,000 of income.

2. Permit qualified members of an affiliated group of corporations to file consolidated returns without incurring the present 2-percent penalty surtax.

These provisions do not provide for elimination of the intercorporate dividend tax where members of an affiliated group do not file consolidated returns, and yet are willing to forego the claiming of multiple surtax exemptions.

The first provision mentioned above, which provides for a penalty tax rate on claiming multiple surtax exemptions, is designed to discourage the formation of multiple corporations solely for tax purposes.

We are particularly in agreement with the second provision; that is, permitting qualified members of affiliated groups to file consolidated returns without the present 2-percent penalty surtax. Under such a provision, businesses carried on through more than one corporation could, where consolidated returns are feasible, be treated as one economic unit for tax purposes. They would be permitted to offset losses of one company against the profits of another, and to receive dividends from other members of the group without imposition of intercorporate dividend tax. As the Ways and Means Committee report states, this provision will also tend to eliminate the use of multiple surtax exemptions, since a consolidated return allows only one surtax exemption for the group.

The committee report also indicates that for technical reasons, complete symmetry between the definition of a controlled group of corporations for purposes of multiple surtax exemptions and an affiliated group of corporations for purposes of consolidated returns, was not attempted. It indicates that the committee knew of no discrepancies in the two definitions which would create substantial hardships, but if such developed, further adjustments to the proposals might be made.

While we do not propose amendments to these definitions, we do suggest that a more complete symmetry should be achieved within the framework of the present definitions. This could be done by permitting qualified members of an affiliated group to receive dividends from other members of the group without imposition of the intercorporate dividend tax even if consolidated returns are not filed, provided only one surtax exemption is claimed for the entire group. Under existing law, these dividends are generally taxed at an effective rate of 7.8 percent. The proposal to eliminate the intercorporate dividend tax in this limited area was included in the original recommendations by the Treasury Department in February 1963 and we believe it to be sound.

The Ways and Means Committee has acknowledged that there frequently are good business reasons other than Federal income taxes, for the use of multiple corporations. On the other hand, there are problems which can make it awkward

or expensive for some affiliated groups to file consolidated returns, although they qualify for the privilege. These problems include the following:

1. Where one or more of the corporations in the affiliated group has minority shareholders, serious problems might arise from a consolidated return. For example, if such a corporation has a net operating loss which is used to reduce the tax of the other members of the group, minority shareholders might object because their company would lose the tax benefits of the carryover or carryback of such a loss. Problems of this sort can be extremely difficult. In fact, there has been litigation on this very point.

2. Where consolidated returns are filed for Federal tax purposes, consolidated returns would also be required by many States for such groups for State income and franchise tax purposes. This could lead to controversies about the allocation of income, and in some cases would produce whimsical variances in State income and franchise taxes.

3. Frequently, members of affiliated groups use accounting periods and methods which for sound business reasons may differ from company to company, although each is appropriate in and of itself for Federal tax purposes. Among these would be differences in taxable years arising from variations in the natural business years of the members of the group. Also, there may be differences in methods of inventory valuation due to variations in trade practices and the like. Other problems, such as differences in various elections under the tax laws, could also arise. If consolidated returns are filed, these differences generally would have to be eliminated and their elimination might well be contrary to good business and accounting practices and give rise to immediate increases and/or decreases in Federal taxes depending upon the circumstances involved in each case.

Problems of this type, together with the very complex nature of the consolidated return regulations, lead many companies to file separate returns. As a matter of fact, the Treasury Department in originally proposing that dividends between members of an affiliated group should not be taxed stated that "this amendment is designed to facilitate the adjustment to the elimination of multiple surtax exemptions where the affiliated group does not, or cannot, file consolidated returns." They recognized that some companies cannot feasibly file consolidated returns. We do not believe that these companies should be penalized because of this. If they cannot obtain the other advantages of filing consolidated returns, it is only proper that they should at least be given equal treatment with respect to intercorporate dividends.

We suggest, therefore, that the elimination of the intercorporate dividend tax be extended to all qualifying members of an affiliated group, whether or not they file a consolidated return. Logically, this should be limited to cases where the group claims only one surtax exemption.

The mechanism of achieving this end would be to increase the dividend received deduction to 100 percent for affiliated groups claiming only one surtax exemption. The choice between claiming multiple surtax exemptions and the 100-percent dividend credit could well be made a binding election, such as the present election to file consolidated returns.

QUALIFIED STOCK OPTIONS

The Ways and Means Committee is to be commended for its decision to continue, in principle, the stock option provisions of the Internal Revenue Code. The committee's action clearly acknowledges the importance to the economy of the purposes served by stock options; namely, making it possible for management and other key employees to acquire ownership of substantial stock interests in their companies and providing them with an effective incentive to improve the profit positions of these companies.

While the changes proposed by the House with respect to key employee stock options would still permit use of such options for the broad purposes for which they are intended, the changes would reduce to a considerable extent the effectiveness of stock options in facilitating the acquisition of stock by key employees and in motivating them to work toward improvement of the long-term profitability of their companies. We believe firmly that it is in the national interest to preserve to the greatest extent possible the features of restricted stock options which give them their incentive value. In this connection, we recommend to the Senate Finance Committee the following modifications in the House bill, H.R. 8363. In formulating these recommendations we have borne in mind the Ways and Means Committee's objective of

correcting abuses in the stock option area, and we believe the modified provisions would still accomplish that objective.

1. The bill would require stock acquired under option to be held 3 years instead of the present 6 months. We recommend a 2-year holding requirement to coincide with the holding period for class A capital gains.

Under existing law, the holding period which is required in order to qualify for the special tax treatment accorded restricted stock options coincides with the 6-month period for which stock must be held by any investor in order to qualify for long-term capital gain treatment. This arrangement has the advantage of being equitable as well as understandable to the holders of stock options, many of whom must be concerned not only with holding period requirements imposed by the tax laws but also with the short-swing insider profit restrictions imposed by the Securities Exchange Act. There appears to be no justification for requiring a longer holding period for stock acquired under options than the one required for class A capital gain treatment, which is 2 years under the House bill. We recommend, therefore, that in the interests of equity and simplicity, the two holding periods be made the same.

It is generally acknowledged that the main purpose of the stock option provisions is to facilitate the acquisition and retention of substantial stock interests by key employees. It should be realized, however, that one of the primary sources of the capital which must form the basis for a continuing stock interest lies in the capital gains which the employee may realize on disposition of part of the shares acquired under his options. Accordingly, excessive lengthening of the required holding period would unduly restrict his ability to acquire this continuing stock interest and would run counter to the objectives of the stock option provisions.

2. The bill would require that the option be exercised within 5 years. We recommend that options be allowed to have a life of 10 years, as under present law, to facilitate exercise of options by younger employees and to encourage employees to take a long-range view of their work.

One of the principal objectives of stock option is to enable key employees of a corporation to obtain a proprietary interest by acquiring ownership of a substantial number of shares of the corporation's stock. A related objective is to encourage these employees to take a long-range view of their work, striving toward steady growth and gradual profit improvement rather than short-term results achieved at the expense of long-term profitability.

In line with these objectives, many effective option plans have provided that the options will have a life of 10 years after the date of grant and will become exercisable in equal annual installments or in varying percentages over the 10-year period.

Reduction of the permissible life of the option to 5 years, as the Ways and Means Committee has proposed, would seriously diminish the usefulness of stock options in attaining either of the above objectives.

First, if the employee is to acquire a significant stock ownership, he must usually borrow a substantial part of the funds required for exercise of the option. This is particularly true in the case of the young up-and-coming employee who has not had the opportunity to accumulate much investment capital. Borrowing is facilitated if the stock has increased considerably in value by the time the option is exercised, because then the amount which may be borrowed by using the option stock as collateral will be greater in relation to the amount the employee must pay for the stock. The longer the life of the option, therefore, the more likely it is that the employee will find a time at which he can conveniently exercise the option.

Second, if the employee is to be encouraged to take the long-range view in his efforts to improve the profitability of the company, the life of the option should be long enough to allow time for long-term programs to influence favorably the company's operating results and, thus, the market price of its stock.

It would be unwise, therefore, to limit to 5 years the permissible length of life of qualified stock options.

3. The bill would require that the option not be exercisable while there is outstanding any previous option. If such a provision is deemed necessary to prevent abuse, we recommend that any unexercisable portion of a previous option not be treated as outstanding for this purpose.

The present regulations covering the resetting of an option price are protective enough to prevent abuses. However, such a practice is widely misunderstood, and we have no objection to a provision which would prohibit it.

However, to include a provision which would unduly restrict the period during which additional options issued to a particular individual could be exercised would impair the effectiveness of option plans and would, in many cases, be inequitable. A close relationship generally exists between the size of the option granted and the importance of the positions held by the grantees within their company. Therefore, the prospect of obtaining additional option grants as an employee advances in the company furnishes a strong incentive to him to qualify for increased responsibility. If the law should be changed to provide that additional options cannot be exercised while other options are outstanding, the effectiveness of stock options as incentives for improved performance will be considerably lessened.

This provision would also discriminate against the employee promoted from within versus the newly hired employee. The latter could be granted an initial option consistent with the position he was assuuming, whereas a promotion grant awarded to the former might have limited value because of restrictions on its exercise which were related to previously granted options.

If some provision of this general type is to be enacted, a previously granted qualified stock option of the installment type should be considered outstanding only if any installments which are exercisable have not been fully exercised. The bill already contains such a provision where the previously granted option is a restricted stock option. Moreover, there would seem to be no reason for requiring that a qualified stock option by its terms must not be exercisable under the stated conditions. It would seem enough to provide that such exercise would deprive the option holder of the tax treatment accorded qualified stock options.

4. The bill would include in income, at time of exercise, 1½ times the amount by which the option price was less than the fair market value of the stock at date of grant. We recommend that only an amount equivalent to the underpricing be included in income, at the time of disposition of the stock.

Present law recognizes the difficulty of valuing stock which is not traded on an exchange or in over-the-counter markets by allowing a tolerance of 15 percent below fair market value in the pricing of restricted stock options. Even with this tolerance, the use of restricted stock options by small companies whose stock is not actively traded is subject to a considerable amount of uncertainty because of the possibility that an examining agent, with the benefit of hindsight, may take exception to the valuation placed on the stock by the company granting the option.

The Ways and Means Committee has proposed that in the event any company issues an option at a price which is to any extent less than the full market value of the stock, the options will be subjected to ordinary income tax, at the time of exercise of the option, on 1½ times the difference between such market value and option price, or the difference between the option price and the fair market value of the share at the time of exercise, whichever is the lesser. This penalty provision would apply to the optionee whether the underpricing by his company had been inadvertent or intentional, and even though the optionee himself had not been a party to the establishment of the option price.

The proposal is most objectionable in that its impact would fall largely on employees of small companies whose stock is not actively traded, and, thus, not capable of precise valuation. Any exercise of an option by an employee of such a company would be a likely target for an internal revenue agent, and the courts would be swamped with valuation cases.

It would be a serious mistake to enact this deterrent to the use of stock options by small companies in attracting and retaining capable managerial and technical personnel. If a penalty provision is deemed necessary, it is suggested that the optionee be taxed at the time of disposition of the stock on an amount which is equal to the lesser of (*a*) the difference between the fair market value at the date of grant and the option price, or (*b*) the difference between the fair market value of the stock at the time of disposition and the option price. Such an approach would subject the full amount of any underpricing to ordinary income tax, but the tax would apply at the time of sale of the stock when the gain is realized (or upon the optionee's prior death) rather than at the time of exercise.

5. The bill would establish the cutoff date for transition from restricted stock options to qualified stock options at June 11, 1963. We recommend that the cutoff date be set no earlier than the date of enactment to permit an orderly changeover to the new rules.

It is strongly recommended that the cutoff date for the transition from "restricted stock options" to "qualified stock options" be established at a date no earlier than the date of enactment, and that companies be given 18 months following the date of enactment in which to (1) amend option plans to conform to any new requirements which such plans must meet and (2) obtain stockholder approval of such amended plans.

While legislative changes are under consideration, companies should be allowed to proceed with the granting of restricted stock options under existing law without having to cope with the uncertainties posed by the prospect of retroacive legislation of an indeterminate nature. Companies cannot be expected to suspend the granting of options while changes are under consideration. Neither can they be expected to grant options which conform to provisions which have not been, and may never be, enacted into law.

If, for any reason, the cutoff date to be included in the final bill is earlier than the date of enactment, it is recommended that the bill be amended to provide that options granted after the cutoff date and on or before the date of enactment may be modified to conform to the qualified stock option requirements without this being considered to be the granting of a new option.

As the Ways and Means Committee report indicates, changes made in the stock option provisions of the code are not expected to have any appreciable revenue effect. Accordingly, in establishing the cutoff date and formulating other transition provisions, Congress should make it as convenient as possible for taxpayers to make an orderly changeover to the new provisions.

6. The bill would require annual information returns by corporations covering transfers of stock to employees upon exercise of qualified or restricted stock options. The need for this information is not clear.

Inasmuch as there are no tax consequences to employees upon issuance of stock pursuant to qualified or restricted stock options, the purpose to be served by such information returns is not clear. Before any such requirement is enacted, taxpayers should be advised of the purpose of the provision and given an opportunity to appraise the necessity for it.

EMPLOYEE MOVING EXPENSES

H.R. 8363 as passed by the House allows a limited moving expense deduction to newly hired employees and to transferred employees who are not reimbursed. This change would alleviate an inequity which exists in the administration of present law and we favor its adoption. However, the bill is silent on the extremely important matter of reimbursed moving expenses of transferred employees, although the Ways and Means Committee report does include the following statement (p. 59):

"Your committee's bill limits the categories of expense for which a deduction is available to new employees or those who are not reimbursed for moving expenses to the three categories specified above (transportation expenses for moving the employee and his family, transportation and certain related costs of moving the personal and household effects of the employee and his family, and expenses incurred for meals and lodging for the employee and his family while they are en route to their new location), which, by ruling, the Internal Revenue Service recognizes as excludable for existing employees. *No inference should be drawn from this, however, that moving expense exclusions under existing law are necessarily limited to these three categories of expenses.* However, since by administrative ruling, these categories are clearly excludable in the case of existing employees who are reimbursed, your committee believed that deductions for such expenses should also be made available to new employees and nonreimbursed employees as well. *The question of whether the exclusion for existing employees extends beyond these three categories is left for judicial interpretation.*" (Emphasis supplied.)

The report (p. 59) also makes reference to two court cases (*John E. Cavanagh*, 36 T.C. 300, 1961 and *Otto Sorg Schairer*, 9 T.C. 549, 1947) in which transferred employees have been permitted to exclude other types of moving expenses, but it goes on to point out that the Internal Revenue Service has not acquiesced in the exclusion of these other types of moving expenses and that the Tax Court has more recently repudiated the earlier *Schairer* decision.

In reliance on the rationale of the *Schairer* decision, many companies have been reimbursing additional types of moving expenses for a number of years and have treated such reimbursements as nontaxable when made to employees transferred from one company location to another for permanent or indefinite duty.

These reimbursements have covered such ordinary and necessary moving costs as house-hunting expenses, costs incident to disposing of a home at the old location and acquiring a home at the new location, temporary traveling and living expenses pending completion of the move, and any loss sustained by the employee on disposition of his home at the old location to the extent such loss was attributable to the move. These companies take the view, and rightly so, that the costs in question are incurred for the convenience of the company, rather than the employee. The reimbursements do not result in financial gain to the employee but merely protect him against a loss of capital as a result of a transfer to a new place of work at the request of his company.

Unless legislation is enacted to make it clear that these reimbursements are not compensatory, the Internal Revenue Service can be expected to continue its present policy of attributing income to transferred employees from such reimbursements. While recourse to the courts is available, the trend in the recent decisions is toward acceptance of the position taken by the Service. In any event, many transferred employees would face the possibility of costly litigation, and the mobility of the Nation's supply of highly trained managerial and technical manpower would be seriously affected.

This problem is an immediate one. In our view, to do as the House has proposed and leave it to the courts to determine the tax status of these reimbursements by interpreting present law would not be a satisfactory solution. If this were done, the uncertainty which now exists, and which is a serious deterrent to the acceptance by employees of transfers which are in the best interest of their employers, would continue for years. We recommend, therefore, that the revenue bill of 1963 be amended to exclude from gross income certain types of moving expense reimbursements paid to a transferred employee and to treat certain others as proceeds of sale of a transferred employee's principal residence.

Attached for consideration are drafts of proposed new code section 121 on moving expense reimbursements and proposed new code section 1003 on determination of amount of gain or loss on sale or exchange of property.

It should be recognized that adoption of these proposals would not result in a significant revenue loss to the Treasury, because to the present the Internal Revenue Service has had little success in obtaining voluntary compliance with the extreme position it has taken at the national office level in the matter of allowable moving expense exclusions.

DRAFT OF PROPOSED ADDITION TO CHAPTER 1, SUBCHAPTER B, OF THE INTERNAL REVENUE CODE, MOVING EXPENSES

SEC. 121. MOVING EXPENSES.

(a) *Exclusion.*—There shall be excluded from gross income of a taxpayer any amounts received from his employer as reimbursement of expenses of moving to a new principal place of work.

(b) *Definitions.*—For purposes of subsection (a), the term "expenses of moving" means:

(1) Traveling expenses, including transportation and means and lodging en route, to the new principal place of work for the taxpayer, his spouse, and others who are members of his household before and after the relocation.

(2) Expenses (including temporary storage expenses) for moving the household goods and personal effects of the taxpayer, his spouse, and others who are members of his household before and after the relocation to the new principal place of work.

(3) Traveling expenses including transportation and meals and lodging of the taxpayer or his spouse, or both, for the purpose of searching for a new place of residence at the new principal place of work.

(4) Any cost of obtaining release from a lease covering property used by the taxpayer as his principal residence at the place from which he is moving.

(5) Legal fees and other expenses incident to the purchase of a new place of residence at the new principal place of work.

(6) Expenses of meals and lodging of the taxpayer at the new principal place of work, pending relocation of the members of his household or while awaiting occupancy of a new place of residence.

(7) Expenses of meals and lodging of the taxpayer's spouse and others who are members of his household before and after the relocation at the new principal place of work, while awaiting occupancy of a new place of residence.

PROPOSED ADDITION TO CHAPTER 1, SUBCHAPTER O OF THE INTERNAL REVENUE CODE, AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

SEC. 1003. AMOUNTS RECEIVED FROM EMPLOYER ON SALE OF RESIDENCE OF EMPLOYEE IN CONNECTION WITH TRANSFER TO NEW PLACE OF WORK

(a) GENERAL RULE.—If—

(1) Property (in this section called old residence) used by the taxpayer as his principal residence is sold by the taxpayer or his spouse pursuant to a sales contract entered into within the forced sale period for the old residence, and

(2) The taxpayer's employer, not later than 1 year after the date such sales contract was entered into, pays part or all of the sale differential on the old residence, then for purposes of this title the amount so paid shall be treated by the taxpayer or his spouse (as the case may be) as an additional amount realized on the sale of the old residence to the extent that it does not exceed the sale differential.

(b) LIMITATIONS.—This section shall not apply unless the taxpayer's new principal place of work—

(1) Is at least 20 miles farther from the old residence than was his former principal place of work, or

(2) If he had no former principal place of work, is at least 20 miles from the old residence.

(c) DEFINITIONS SPECIAL RULES.—For purposes of this section—

(1) FORCED SALE PERIOD.—The term "forced sale period" means the period beginning 90 days before, and ending 180 days after, the date on which the taxpayer commences work as an employee at the new principal place of work.

(2) SALE DIFFERENTIAL.—This term "sale differential" means the sum of:

(a) The amount by which the appraised value of the old residence exceeds the gross sales price of the old residence, plus

(b) Selling commissions, legal fees, and other expenses incident to the transfer of ownership of the old residence

(3) APPRAISED VALUE.—The appraised value of the old residence is the average of two or more appraisals of fair market value made, on or after the valuation date and on or before the date on which the sales contract is entered into, by independent real estate appraisers selected by the employer. Determination of appraised value shall be made as of the valuation date.

(4) VALUATION DATE.—The term "valuation date" means the date selected by the employer for purposes of determining the amount to be paid with respect to the sale differential. Such date shall be on or before the date the sales contract is entered into and within the forced sale period.

(5) EMPLOYER.—The term "employer" means the person who employs the taxpayer as an employee at the new principal place of work.

(6) EXCHANGES.—An exchange by the taxpayer or his spouse of an old residence for other property shall be treated as a sale.

(7) TENANT-STOCKHOLDER IN A COOPERATIVE HOUSING CORPORATION.—References to property used by the taxpayer as his principal residence includes stock held by a tenant-stockholder (as defined in sec. 216) in a cooperative housing corporation (as defined in such section) if the house or apartment which the taxpayer was entitled to occupy as such stockholder was used by him as his principal residence.

(a) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.

THE PROPOSED REPEAL OF THE DIVIDEND CREDIT

In its report accompanying H.R. 8363, the Ways and Means Committee of the House of Representatives set forth two major objectives of the legislation. One is to lower tax rates so that the free enterprise system can generate the higher rate of economic growth which our economy requires. The other is to improve the equity of the tax laws by removing or altering features of the tax provisions which are generally considered to be unfair.

Section 201 of the proposed legislation, relating to the dividend credit and exclusion, however, appears to be at cross-purposes with these objectives. Rather than reducing taxes, this provision would increase the taxes of about 2.5 million

stockholders. Rather than permitting the private economy to generate a higher rate of economic growth, this provision will erect a barrier to investment in common stock. Rather than improving the equity of the tax laws, this provision would reestablish an inequity which Congress moved to correct in the Revenue Act of 1954.

Thus, while there can be agreement on the objectives of the bill, it is difficult to find a valid reason for the inclusion of section 201. Both equity and economics dictate that the tax structure provide a means of offsetting the effects of double taxation of corporate income paid out as dividends. Although the present dividend credit and exclusion are not ideal as methods of dealing with this problem, or adequate in the amount of relief they provide, they should not be abandoned in favor of a method which would be even less adequate or equitable. Within their limitations they have proven effective in encouraging common stock investment and in reducing the burden of double taxation for all stockholders. In our view therefore, proposed section 201 should be deleted prior to final passage of the legislation.

THE REASON FOR THE DIVIDEND CREDIT

It is widely recognized that double taxation of dividend income is inequitable because it results in a heavier tax burden on income from corporate earnings than on income from other sources. Wages or salaries, interest, and rents are deducted from corporate income before tax and taxed only once as income to the recipients. Earnings of proprietorships and partnerships are also taxed only once as income of the owners. In contrast, corporation earnings paid out as dividends are taxed once when earned by the corporation and again when received as income of the stockholder.

Under the rate schedules proposed in H.R. 8363, for example, corporate earnings paid out as dividends would be subject to combined effective tax rates ranging from 55 to 84 percent. (These rates are computed as the sum of the 48 cents paid in corporate tax on each dollar of corporate income, and the individual rates of from 14 to 70 percent applied to the remaining 52 cents assumed paid in dividends.) Thus the combination of these elements results in an effective tax at a substantially higher level than the rates applied to income from other sources.

In the Revenue Act of 1954, Congress recognized both the inequity and restrictive effects of double taxation. The report of the Senate Finance Committee on that legislation,[3] points out for example that double taxation "* * * has contributed to the impairment of investment incentives. Capital which otherwise would be invested in stocks is driven into channels which involve less risk in order to escape the penalty of double taxation. This restricts the ability of companies to raise equity capital and has forced them to rely too heavily on borrowed money. The penalty on equity financing has been especially harmful to small business which cannot easily borrow funds and must rely on equity capital for growth and survival."

To offset these effects, Congress adopted the dividend credit and exclusion. These two provisions permit the taxpayer to exclude a small amount of dividends from income and allow him a credit against tax equal to 4 percent of the dividends received in excess of the amounts excluded.

This legislation has come under attack in the past by some who assert either that the corporation is a separate entity with a taxpaying capacity of its own or that the tax is somehow passed on in the form of higher prices, lower wages, or a price for corporate equities which takes the tax into account. The first of these arguments, however, ignores the relationship of the stockholder and his corporation. There appears to be no more merit in considering a corporation as separate from its stockholders for tax purposes than in considering a partnership or proprietorship as divorced from its owners. Proponents of the second view have been unable to produce empirical evidence to support their position.

It is significant that although these arguments are recognized in Secretary Dillon's testimony, no attempt is made to support them and, in fact the administration's case for repeal of the dividend credit is based on entirely different grounds. Secretary Dillon contends that the dividend credit has been ineffective and further asserts that it benefits stockholders in the upper brackets more than those in the lower brackets. It is to these aspects of the problem, therefore, that the balance of this statement will be devoted.

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[3] Internal Revenue Code of 1954, report of the Committee on Finance, U.S. Senate, to accompany H.R. 8300. Rept. No. 1622, 83d Cong., 2d sess., June 18, 1954, p. 6.

EFFECTIVENESS OF THE DIVIDEND CREDIT

Consideration of the effectiveness of the dividend credit raises questions as to both our past experience and our probable future need. The dividend credit and exclusion has been in effect since 1954 and there is, therefore, a background of experience to which we can refer. Merely reviewing historical statistics, however, neglects the equally important question of the contribution which the dividend credit can make to a solution of our foreseeable future problems.

One thing that stands out is that, in either context, the role of the dividend credit is limited. It cannot be said that the dividend credit, taken by itself, is the dominant consideration in investment decisions. Rather, it is one factor among several that influence capital flows. It has the effect of increasing effective yields on equities and thus encouraging equity investment. Equity investment in turn provides the base on which additional loan capital flows into industry.

There is a major task ahead in raising sufficient capital to finance the expanded rate of growth that our economy will require in the next few years. Acting at the margin, the dividend credit undoubtedly has and will continue to influence some investors toward equity purchases. It can be expected that the dividend credit will continue to exert a positive and constructive influence, and that it will be instrumental in achieving the objectives of more rapid growth and lower unemployment. There may well be merit, therefore, in considering ways of strengthening the dividend credit, rather than eliminating the relief from double taxation which it currently provides.

The record since 1954

Secretary Dillon's testimony before this committee on H.R. 8363, contains a lengthy discussion of the effectiveness of the dividend credit from the administration viewpoint. One of the Secretary's major points is the assertion that the dividend credit has been ineffective because "in the period 1954–62 there has been no significant change in the ratio of stock to total corporate external financing." This statement is based on table 12 of exhibit 3 to the Secretary's testimony. A somewhat different inference appears warranted, however, if table 12 is analyzed by comparing data for the 8 years prior to 1954 with that for the 8 years following, as is done in the tabulation below:

Corporate external financing

[Dollar amounts in billions]

	1946–53	1955–62
Stocks	$15.2	$26.4
Bonds and other long-term debt	35.8	55.9
Total	51.0	82.3
Percent of stock	29.8	32.1

On this basis it is clear that the volume of equity financing was sharply higher in 1955–62 than in the earlier period. This can be interpreted as an increase in the seed capital or equity base of industry. It supported the increase in the sale of bonds and other long-term debt as is indicated by the relatively constant ratio between stocks and debt instruments in the two periods. Thus, although the increase in the ratio of stock to the total of stock and debt from 29.8 to 32.1 percent may not appear to be a major improvement it does reflect the sharp increase in the flow of seed capital into industry and is probably about as much of an increase in the ratio as could be expected in view of the meager relief given by the 4-percent dividend credit.

Secretary Dillon's argument that the dividend credit and exclusion are inferior to the investment credit or the reduction in the corporate tax rate in encouraging equity investment approaches the irrelevant. Neither of these attacks the problem of the double taxation of corporate dividends. The benefits of the reduction in corporate taxes will be delayed for several years pending the completion of the acceleration of payments provided for in H.R. 8363. It is still undetermined whether the new depreciation guidelines and investment credit will have the effect of increasing the amount of funds available for the payment of dividend. In any case, reduction in the corporate rate and provision of new

depreciation guidelines are measures which can be justified in their own right, and there is no reason to regard the as substitutes for the dividend credit.

The apparent cause of error in Secretary Dillon's analysis seems to be that there simply is no data to support his point of view. During the period that the dividend credit has been in effect there has been a tripling in the number of stockholders, the proportion of stocks to bonds and other long-term debt in total corporate external financing has increased, and the pool of available funds that corporations can tap in the sale of equities has expanded. While there appears to be no way to measure the influence of the dividend credit in bringing these changes about the facts support the view that, to the limited degree that could be expected, the dividend credit has encouraged equity investment.

The years ahead

More important than the varying interpretations that can be placed on particular statistics, is the question of the probable future effect of a repeal of the present modest relief from double taxation. Two such future impacts must be considered. One is the psychological effect on investors. The other is the impact of repeal on the merit of common stock as an investment medium.

The nature of the psychological effect has been well described by Dan Throop Smith, the former Assistant Secretary of the Treasury, who has pointed out that—

"The dividend credit at the time of its adoption had a symbolic importance much greater than its monetary significance. The full double taxation of dividend income in 1936 was regarded as being symptomatic of a punitive attitude toward private enterprise. Relief was urged to remove this symbol of a penalty, and the adoption of the exclusion and credit was in response to the widespread belief that there should be some reduction in the double tax. The repeal of the relief would symbolize a revival of the punitive attitude toward the worth of risk capital, equity funds for business, which is of such vital importance for continued economic expansion. Our relief is extremely modest compared to what is done in many other countries, both highly developed and underdeveloped. Removal of this very modest relief would be a sign of retrogression; we should not fail to look to the north, where Canada for many years has given a 20-percent credit against dividends, a figure which exceeds their first-bracket tax rate, though it exactly equals our own." [3]

No less important is the effect of repealing the dividend credit on common stock as an investment medium. Economic discussion in recent years has emphasized the need for attaining a more rapid rate of economic growth. This can only be achieved, however, in company with a parallel expansion of corporate activity and this, in turn, requires the availability of ample funds for equity investment.

Funds to finance corporate growth must come from one of three sources—borrowings, retained earnings, or new equity investment. Borrowing is limited by the need for an adequate equity base and the traditional limits which lenders place on the extent to which such funds will be advanced. Although retained earnings have been an important source of funds in past years, the recent record shows that the proportion of corporate earnings paid to stockholders as dividends increased from 49 percent in 1955–56 to 58 percent in 1959–60 and to 67 percent in 1962–63. As a result, retained earnings declined from $11.8 billion in 1955 to $6.5 billion in 1961, although there was some recovery to $8.1 billion in 1962. In future years, therefore, it appears likely that increased reliance must be placed on stock issues as a source of funds required to finance corporate expansion.

A dramatic illustration of the nature of the problem was recently provided in connection with the action of the American Telephone & Telegraph Co. in raising its dividend. In the press release announcing its move, the company noted that it is planning the largest construction program in its history for 1964. Further, the company said that it "believes that the dividend increase and stock split will make A.T. & T. stock more attractive to individual investors, widen the market for the stock and facilitate the raising of the large amounts of new capital required for its construction program."

To the extent that the dividend credit increases the effective yield on equities, it also makes equity investment more attractive to individuals and widens the market for stock issues. At the same time, repeal of the dividend credit

[3] Dan Throop Smith, "Tax Treatment of Dividends" in "Tax Revision Compendium," papers submitted to the Committee on Ways and Means, House of Representatives, Nov. 16, 1959, vol. 3, p. 1548.

can have no effect other than to erect a new barrier to the flow of capital into corporate equities. This, in turn, will inevitably impose a hardship on existing firms, and a barrier to the creation of new firms, with negative effect on the rate of economic growth and the expansion of employment opportunities.

THE INCIDENCE OF TAX RELIEF

Much of the administration's case for repeal of the dividend credit is based on the assertion that the present provisions favor individuals in the higher income brackets. The Ways and Means Committee report on H.R. 8363, for example, states that "Information presented by the Secretary of the Treasury to your committee indicated that the dividend credit, even combined with the present exclusion, reduces the extra burden of taxation by 10.4 percent in the highest income bracket, while reducing it by only 4.3 percent for those subject to the first bracket rate."

In support of his view, Secretary Dillon presents in exhibit 3 of his testimony, two tables which purport to illustrate that the dividend credit relieves a greater share of the burden of double taxation for individuals in the higher income brackets. It is evident, however, that these tables must be interpreted with great caution. By virtue of the fact that the calculations make no allowance for the effect of the dividend exclusion, the tables substantially understate the amount of relief provided those in the lower income brackets. Similarly, by ignoring the fact that the amount of the credit cannot exceed 4 percent of the taxpayer's income, the tables overstate the amount of relief provided those in the higher brackets.

Again, one must view with skepticism the Secretary's efforts to create the impression that the effect of the changes which are proposed in H.R. 8363 will be wholly favorable to those in the lower income brackets while eliminating the especially favorable treatment which is presently accorded taxpayers in the upper brackets.

In exhibit 3 to his statement before this committee, Secretary Dillon states that the taxes of about 2.5 million of the 6.2 million taxpayers who receive dividend income would be higher under the proposals in H.R. 8363 than they are under present law. At another point the Secretary refers to those "few people" who would be adversely affected by repeal of the credit and doubling of the exclusion despite the individual tax cuts and despite the new minimum standard deduction.

Some light on the real impact of the proposed changes can be gained from tables 3 and 4 appended to Secretary Dillon's statement to this committee. As shown below, the total net effect of the proposed structural changes in H.R. 8363 is to increase taxes in the aggregate by $575 million. Of this total, $450 million or 78.3 percent will be paid by the 29.6 million taxpayers who are in the adjusted gross income classes between $5,000 and $20,000. Roughly one-fourth of this additional burden or $80 million is expected to result from the repeal of the dividend credit and the increase in the exclusion.

There are only 1.2 million taxpayers in the adjusted gross income classes above $20,000. The vast majority of the 17 million stockholders, then, fall in the lower income classes. Repeal of the dividend credit will clearly affect many of the 22.9 million taxpayers in the $5,000 to $10,000 class and the 6.7 million in the $10,000 to $20,000 class.

Adjusted gross income class (in thousands of dollars)	Effect of all structural changes		Effect of repeal of dividend credit and increase in exclusion (millions of dollars)
	Millions of dollars	Percent	
0 to $3	−155	−27.0	(1)
$3 to $5	−35	−6.1	+10
$5 to $10	+255	44.3	+30
$10 to $20	+195	33.9	+50
$20 to $50	+130	22.6	+85
$50 and over	+185	32.2	+125
Total	+575	100.0	+300

[1] Less than $2,500,000.

Certainly no change in the tax laws that has a major impact in these income classes can be thought of as being of special concern to wealthy individuals. The below $10,000 classes include families with less than average income and the proposed elimination of the credit will cost them $40 million. The $10,000 to $50,000 income classes include those who are just above average income and are characteristically those who are willing to accept relatively large risks in the hope of gaining a strong financial footing. It is this group, too, who will provide much of the venture capital which the economy will need during the coming years. Almost half the burden of the proposed elimination of the dividend credit, $135 million, will fall on this group.

In view of the weight of the proposed changes on taxpayers in the lower and middle income brackets it is somewhat surprising that Secretary Dillon regards them necessary "to justify the rates adopted for the middle and upper income brackets." Many witnesses have noted the steep graduation in the proposed rates through the middle-income brackets. Clearly, the changes envisioned in section 201 will further burden the middle income-tax payers. Thus, the proposed change will impose severe pressure on those who are currently making an above-average contribution to the economy and on whom we depend for future leadership and capital.

The problem that is presented by this inequity is closely tied to the larger problem of the growth of the economy. It has been shown on many occasions that the taxpayer in the above-average income brackets is the individual with the talent, initiative, and willingness to accept the risks inherent in investment in new and untried enterprises or in major expansions of older firms. In fact, this type of situation has become widely known as a businessman's risk.

Clearly, the economy can't have it both ways. If the income of these individuals is siphoned off in oppressive taxes, the required investment will not be forthcoming. If the tax barrier to investment is lowered or removed, the benefits will become apparent in future buoyancy and growth.

Also, it is unrealistic to assert that the reduction of other taxes on personal or corporate income will take the place of the dividend credit and exclusion. Investment funds inevitably seek the highest return. As long as double taxation of dividend continues, it will inevitably bias investment against corporate activity and into other channels. Adoption of section 201 could seriously damage the standing of common stock among investors.

Equity of the dividend credit

The point most emphasized by Secretary Dillon in his opposition to the dividend credit is his contention that it is inequitable, giving greater relief from double taxation to the upper income groups than to the lower. This in turn is supported by elaborate exhibits in which the "burden of double taxation" is calculated for individuals at various marginal tax rates.

In the Secretary's exhibits the "burden of double taxation" is computed as the amount the individual would have had left, after payment of his personal tax, on the amount paid in corporate tax if instead this latter amount had been paid to him in dividends. Thus out of the 48 cents to be paid out of each dollar of the corporation's income, the stockholder in the 70-percent bracket would have only 14.4 cents left, whereas the stockholder in the 14-percent bracket would have had 41.3 cents left. Thus it is concluded that the stockholder in the low bracket bears a greater burden of double taxation than the stockholder in the higher bracket, and therefore a flat-rate credit is inequitable.

The Secretary's arithmetic is unassailable, but as a guide to national policy in dealing with this problem it is entirely unrealistic. It implies that, the higher the rate of an individual's tax on the dividends he receives, the less deserving he is of relief from the burden of double taxation. In fact, this system of computation would lead to the conclusion that if an individual paid 100 percent personal tax on his dividends he would suffer no burden of double taxation.

It also leads to the peculiar conclusion that by reducing the top rate of individual tax from 91 to 70 percent, Congress would have more than tripled the burden of double taxation on individuals subject to this rate—from 4.3 cents per dollar of original corporate income to 14.4 cents.

It has been suggested by the Secretary that, if the dividend credit were retained, the top rate would have to be raised as an offset. But his own method of calculation would lead to the conclusion that raising the top rate of tax would actually reduce the burden of double taxation.

Clearly a method of analysis which leads to these absurd conclusions is not to be taken seriously. This is the major basis for Secretary Dillon's contention that the dividend credit is inequitable in giving greater relief to high-bracket individuals than to those in lower brackets.

CONCLUSION

We appreciate the opportunity that has been provided to present our views on the dividend credit and exclusion to this committee. In conclusion it may be helpful to summarize by emphasizing the following points:

1. As a result of double taxation, income from corporate earnings bears a heavier tax burden than that from other sources. Congress has recognized that this is inequitable and acts as a barrier to investment in common stock.

2. If the objective of a higher rate of economic growth is to be realized, it will be necessary for corporations to increase the amount of stockholder equity in their capital structure. Retained earnings cannot be expected to prove an adequate source of funds and borrowing must be restricted to a reasonable proportion of the total capital employed.

3. Secretary Dillon's contention that the dividend credit and exclusion have not been effective in stimulating the purchase of common stock is not proven by the statistics he presents. In fact, although it is impossible to measure the precise role of the dividend credit and exclusion, the amount of stock sold in the 8 years following 1954 was substantially greater than the amount sold in the 8 years preceding.

4. At the same time, it is a reasonable expectation that repeal of the dividend credit will have the effect of restricting the future sale of stock. For one thing, it would be a tacit admission that the punitive attitude toward corporate activity had been reestablished. In addition, it could have deleterious effects on the attractiveness of common stock investments.

5. It is equally clear that the proposal in section 201 that the exclusion be doubled and the credit repealed is highly unsatisfactory. This proposal actually gives little additional benefit to those in the lower bracket. Above the lower brackets, however, the relief afforded declines sharply from bracket to bracket thus increasing the inequity of the tax system.

6. In the absence of compelling reasons to believe that the dividend credit has been ineffective in stimulating the purchase of common stock; in view of the demonstrable inequity that would result from eliminating the dividend credit and doubling the exclusion; and in light of industry's need for increasing amounts of equity capital, it is our view that the proposed change in the dividend credit and exclusion is unwise and will hamper the future growth of the economy. We recommend, therefore, that proposed section 201 of H.R. 8363 be deleted before final passage of the legislation.

NEW YORK, N.Y., *December 6, 1963.*

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Authors League of America, a national society of writers and dramatists, respectfully requests leave to submit this statement in support of the 5-year "averaging" provision contained in section 221(a) of the revenue bill of 1963. And, we ask that this letter be included in the record of the hearings on the bill by the Committee on Finance.

As President Kennedy had noted, when the averaging plan was first proposed by the Treasury, it would provide "fairer tax treatment for authors * * *" and other taxpayers who receive unusually high income in 1 year compared to their average income in preceding years.

A 5-year "averaging" plan would effect more equitable tax results than the present averaging provision of section 1302

The Authors League has previously recommended that Congress adopt an averaging provision. It is sorely needed by novelists, dramatists, and other self-employed authors and there is sound justification for such a measure under principles already embodied in the Internal Revenue Code.

The author's tax problem is not simply a matter of "fluctuating income." The self-employed author receives his income from royalties or other compensation derived from the publication (or production) of his book or play. This income is attributed (for tax purposes) solely to the year of receipt—although it

is often the result of writing done over a period of 2, 3, or more years. Had he received the same income proportionately during the period he worked on his book (as he might, had he written it as an employee), his total tax burden would have been much lower. During that period, being self-employed, he received little or no income for writing the book; and because he was engaged in writing it, had less opportunity to earn income from other sources. Consequently, if the bunched income were averaged over those years it would have fallen into lower brackets.

Recognizing this problem, the Internal Revenue Code now provides (sec. 1302) that such "bunched" income may be taxed as if it had been received over the period of creation—if certain conditions are met. Unfortunately, section 1302 has proven, in Secretary Dillon's words, to be "a narrowly confined and complex averaging provision." The code now required that "bunched" income can only be averaged if it is 80 percent of all income derived from the book (or play) in the taxable year, the following year, and in all prior years.

This condition is impossible to meet in most instances because it does not jibe with the business patterns of book publishing and the theater. The income from a successful book or play is concentrated in a period of a few months following its publication or production; but that period frequently overlaps 2 taxable years. A book published in the fall, if successful, will be sold into the spring of the following year. Similarly, a play produced in October or November, will run into the next year.

Consequently, although as much as 50 to 75 percent of the income from a book or play may be received in the tax year in which it was first published or presented (a concentration that can be disastrous under present tax rates) the averaging relief of section 1302 is unavailable because of the 80-percent requirement (and the inclusion of the following year in the base period).

Another limitation of the section is that it restricts the spreadback period on a literary work to 36 months even though it may have been written over a much longer period—although inventors are entitled to a spreadback of a maximum of 5 years; and lawyers, accountants, and other professionals may average back income (sec. 1301) over the entire period in which long-term services were performed.

A 5-year averaging plan would not have the unduly restrictive conditions of section 1302; and would therefore relieve more authors of the inequity that results when income from a book or play written over 2, 3, or more years is received, "bunched," in a 1-year period.

Moreover, as Secretary Dillion has observed, an averaging plan would be much simpler to administer and apply than the present spreadback system. It would eliminate disputes as to when work on a book or play commenced (often difficult to establish) and there would be no need to recompute taxes for prior years.

An averaging provision would enable authors to offset losses and retain sufficient professional working capital

The income from a successful book or play represents the working capital on which a freelance author must draw to support himself and his family, if he is to continue in the profession of writing over a long period. Often the fruits of one book may have to provide the funds on which he must draw for 4, 5, or even more years; not only because one book takes a long time to write but because his investment of time, talent, and money in a particular book or play may be a total loss if it is a financial failure. This means that the successful book must carry the author for that much longer a period of time. The risk of loss is as common to the literary profession as to any other business or venture. And, ironically, the author's loss often occurs with a book or play that is an artistic success, and that may be successful years later, sometimes after it has passed into the public domain.

At the present time there is no provision in the code which enables the author to offset these losses against the profits from a successful work. Since these profits are attributed to the year of receipt and consequently taxed at higher rates, it is exceedingly difficult for the author to retain sufficient income to remain in the writing profession, to accumulate the means for professional survival.

This is not a problem of sporadic income; it is not caused by intermittent or casual employment. The author has these cyclic periods of low income because he is working; and because while he is engaged in writing, on a self-employed basis, he receives little income.

What the author requires is a measure of the assistance which Congress gives other taxpayers, to enable them to offset a portion of income in profitable years against losses in other years. For example, the code (by loss carryover and carryback provisions) assists other taxpayers to continue in business in years when they have sustained losses—by permitting them in effect to exclude a portion of their income in profitable years from tax; income that would be taxed in full if, as in the author's case, the profitable year were isolated from prior or subsequent loss years.

An author cannot offset the loss of his investment in a book or play that fails; although he has invested in its creation years of his life, his savings to support himself and his family, and a creative talent for which motion picture companies, television producers, or other employers would have paid thousands of dollars. An averaging provision would permit him to offset such losses.

Various provisions in the code (the carryover section, amortization, depletion allowances, and capital gains treatment) were adopted (and justified) as incentives to encourage individuals to carry on occupations which benefit the country, and as protective devices to minimize the economic risks and hazards inherent in them. The profession of writing meets all of these qualifications, admirably. It involves economic risks and hazards seldom matched. Its contributions to the country equal those made by most occupations that do receive protection. There is therefore a strong justification to provide the author with decent tax treatment not only so that he can maintain the minimum income to survive in his profession over a period of time; but also to provide a sufficient reward and incentive to encourage him to enter the profession or stay in it.

The great works in our literature and theater have been created by freelance writers—self-employed authors writing books and plays they believed in.

But many writers now forego, temporarily or permanently, freelance writing for the security and higher income they can obtain writing as employees of motion-picture companies, television networks, and advertising agencies. The risks are less; the rewards are greater. The fact that they receive a constant salary, while they are writing, provides a form of averaging that leaves them greater income, after taxes, than they would have had from the same return in the form of royalties (concentrated in the year of publication or performance of a successful book or play). Tax assistance that will increase the incentive to the author to forego the security and rewards of employment, for the risks and hazards of independent writing, will enable more writers to devote themselves to the kind of writing that is of greatest value to our culture.

An averaging provision would give some measure of that assistance.

Therefore, the Authors League of America respectfully urges that your committee approve section 221(a) of the revenue bill of 1963, providing for the computation of taxes on fluctuating income on an averaging basis.

Respectfully yours,

THE AUTHORS LEAGUE OF AMERICA, INC.,
By REX STOUT, *President*.

(Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Monday, December 9, 1963.)

REVENUE ACT OF 1963

MONDAY, DECEMBER 9, 1963

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 (chairman) presiding.

Present: Senators Byrd, Long, Gore, Talmadge, Williams, Carlson, Bennett, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

At the request of Senator Gore, the Chair places in the record a reprint of an article by Mr. Henry Ford II which appeared in the July–August 1961 issue of Harvard Business Review, entitled "Stock Options Are in the Public Interest."

This was discussed when Mr. Ford appeared before the committee on November 4, 1963, in part 3, at page 1286.

(The article referred to follows:)

[From the Harvard Business Review, July–August 1961]

STOCK OPTIONS ARE IN THE PUBLIC INTEREST—SAYS THIS COMPANY PRESIDENT; THEY PROVIDE A VIGOROUS INCENTIVE FOR ONE OF OUR MOST IMPORTANT NATIONAL RESOURCES, MANAGEMENT

(By Henry Ford II)

(EDITOR'S NOTE.—When Mr. Ford wrote this article he was president of the Ford Motor Co.; just recently he relinquished the presidency, and is now chairman of the board of that company.)

Economic incentive is a subject of continuing controversy spanning a broad range of political and economic viewpoints. Recently, a relatively new form of economic incentive, the restricted stock option, has been singled out for critical attention. Some of this criticism is constructive and is aimed at improvement of the law governing stock options. Some of it seems directed at destroying the restricted stock option provisions of the law.

I have a particular interest in restricted stock options because, as the chief executive officer of Ford Motor Co., I am explicitly accountable to nearly a quarter of a million stockholders for the good or bad management of the company, the success or failure of the business. And I feel qualified to speak more or less dispassionately on this subject because, although I am familiar with the uses and effects of stock options, I do not and will not hold any options on stock of our company.

I am convinced that the restricted stock option is a powerful incentive to good management and an important contributor to economic progress—and that it can be made to serve still better the broad goals of our society.

NEED FOR REALISM

I am aware, of course, that there have been imperfections in the administration of certain stock option programs and that, in a few cases, the good and

constructive intent of stock options may have been thwarted. This is not at all surprising in view of the brief history of this form of incentive and its admitted complexities. If management still has much to learn about stock options, however, it already has learned a great deal about the efficient, productive use of this device and has, by and large, corrected many of the shortcomings to which critics of the stock option have pointed in alarm.

The real question is, How are stock options working today?

Both the law and the administration of options undoubtedly can be improved. Careful consideration should be given to further study to determine whether specific provisions of the law should be modified. As for administration, if stock options amount only to unearned and quickly realized bonanzas rather than to continuous inducement to better performance and if the optionee gains no real and lasting sense of proprietorship in the business, management is guilty of misusing one of the most effective tools at its disposal.

But certain other common criticisms of restricted stock options appear to me to be the result of too little objective information and, for that reason, are greatly exaggerated. I want to deal with these in some detail later in this article. First, however, I should like to state why I believe that stock options produce good and useful results, and why we should attempt to improve, rather than limit, the effectiveness of this important economic incentive.

The Ford story

During the early postwar years at Ford Motor Co., a dozen or so skillful men—executives brought in from outside after the war—transformed a bogged-down, antiquated, money-losing company into a modern, efficient, profit-making enterprise, capable of meeting the toughest kind of competition, of improving its position, and of renewing its own management resources. Largely through the efforts of these men, the company became a substantial net contributor to the managerial and technical capabilities of the economy. Furthermore, by stimulating more intense competition in the automobile industry, the company added to the general prosperity and growth of the 1950's.

Without the guidance of these men, the stockholders' equity might be half of what it is today. The contribution of this group to the growth and profits of the company has far exceeded any financial rewards they received in return. Many of these executives were already established, successful, and well paid. We could not have offered them enough more in salary and possible bonuses to justify the risk of leaving secure positions for the uncertainties of our situation. They joined Ford Motor Co. largely upon my promise that I would do my best to give them an opportunity to acquire a stake in the company as soon as it was feasible to do so.

At the same time, we also developed a group of exceptionally able younger men who contributed materially to the company's growth and who were not being rewarded commensurately with their contribution. These young men—including a number of the leading executives of the company today—saw opportunities for realizing large capital gains outside the company. Some outstandingly capable people left us for that reason. Indeed, at one time, before we could offer stock options, we had a serious problem with sales executives leaving us to go into business for themselves as dealers.

When the Congress authorized restricted stock options by amending the Internal Revenue Code, it gave us an effective means to recognize and stimulate exceptional performance, and to protect the company's future by conserving its management "seed corn." In 1953, when our only shareholders were members of the Ford family and the Ford Foundation, the board of directors made its first grants of restricted stock options to 114 key employees, thus breaking a tradition of long standing. Stock options have since been offered from time to time to key employees.

We have had no reason to regret that decision. I am convinced that, in broad effect, stock options have helped materially to raise the company to third place among American industrial corporations in total dollar sales. Without stock options or some comparable incentives, the same results would not have been achieved.

A NATIONAL RESOURCE

The use of stock options to attract and hold managerial talent is not without public interest.

Companies, big or little, don't just roll along. Certainly, the quality of top management among corporations is the main differentiating factor. Manage-

ment, good or bad, determines whether any one company grows or declines, succeeds or fails over the long pull. Even in a large company, the influence on profits of one or two men is likely to be very great, and the general ability and dedication of the top 100 men can make or break any company. That is why knowledgeable investors assess the caliber of a company's management before they buy its stock.

And if able management is critical to the individual company, in the aggregate it is equally critical to the whole economy. Good management of private business insures maximum growth in the economy, while poor management impedes that growth, wastes capital and labor, leads to stagnation. Thus, because the productivity of capital and labor is so closely tied to the quality of management, everybody's income and standard of living—as well as our national security—depend heavily on how well managers do their jobs.

But management talent is a scarce and very precious national resource. To make the most efficient use of this national resource, we must find ways to put and keep our best business managers in the most important jobs—jobs that make the broadest use of their talents and have the greatest impact on the society's total economic performance.

Once we have managers in these important jobs, the next essential step is to provide incentives for them to work most effectively and productively.

Monetary incentives

Yet some people deplore the emphasis our economic system places on the monetary incentive, both for individuals and for business enterprises; the desire for gain, for material recognition, is linked with the sins of greed and gluttony.

I know that monetary incentive is important in getting men to produce the results that a corporation must have if it is to survive and prosper. It follows that monetary incentive can and does serve society well. I reject out of hand the notion that such incentive is unworthy or reprehensible.

While I certainly agree that there are many kinds of incentive, and many kinds of men, and that more money does not necessarily make a hard-working man work harder. I completely disagree with the idea that monetary gain is an unimportant incentive. For executives in the business world, it would seem axiomatic that the money incentive is primary, just as the drive for profit is a prime incentive of individual business firms and, indeed, of the whole economy.

So long as such drives may be harnessed to good ends, I can see no reason to be disturbed or ashamed that the acquisitive instinct is strong in men, that most of us do have aggressive drives and ambitions. It is the very genius of our economic system that it channels these powerful, potentially destructive, personal drives into the highly organized, cooperative management systems that have contributed so much to our Nation's well-being.

Our system works well because it persuades managers that they are working for themselves when they are, in reality, serving the total economy. Actually, they are unable, as a rule, to keep more than a token of the wealth that their efforts create.

I often wonder whether the really important distinction between private enterprise and socialism is not the superior motivation that our system offers. We sometimes forget that one of the great advantages of our economic system is that in it capital may be privately owned. Our system uses capital not merely for investment but also as a potent incentive to risk, invent, and persevere. If the Communists could find a way to match the incentive that is in the drive of individuals to acquire capital, they might be hard to beat.

Ideally, our whole economic system should be geared to provide maximum opportunity to each generation. We should seek ways to increase manifold—rather than decrease—the number of people who can hope to achieve substantial wealth. Is there any better way to do this than by enhancing their opportunity to contribute to the economy? It seems not only just but productive that the people who contribute substantially to the economy should own at least a part of the capital.

Soviet imitation

Today, a very live subject in Soviet economic journals is the improvement of personal incentive throughout Soviet industry. Here are some statements from recent articles by Russian management experts:

"The present system of bonus payments * * * provides little stimulus to managerial and engineering and technical personnel. * * *"[1]

"Managerial and engineering and technical personnel are, to a substantial degree, responsible for success * * * a substantial portion (let us say 15, 20, or 30 percent) of the total bonus fund should be set aside for this category."[2]

"One of the conditions for raising the economic level of the enterprise's work is the establishment of economic stimuli and insuring the interest of the leadership and the collective body of the enterprise. * * * One of the measures designed to increase this interest could be the establishment of a procedure under which a larger part (of profits) would be included in the enterprise (or bonus) fund."[3]

The very time at which our country's foremost competitors are improving the effectiveness of their monetary incentives—incentives that are not, as ours are, greatly weakened by progressive income taxation—is obviously not the time to be weakening our own.

By all sound means we should endeavor to increase the rate of our economic growth to the end that we may be more effective in meeting the economic and political challenges of those who seek to dominate the world. The way to do that is to take out of our sysem the things that slow it down (featherbedding, resistance to technological change, and the like), and put in more of the things that encourage inventors to invent, artists to create, entrepreneurs to risk, and managers to manage wisely and well.

In a free enterprise economy, good management is profit-conscious management. And don't forget that society depends on this kind of management to generate the national production to support nonprofit institutions such as hospials, schools, research organizations, and government, and social benefits such as unemployment compensation and social security.

DOUBLE-BARRELED EFFECT

It was the clear and deliberate intent of the restricted stock option legislation to strengthen incentives to good management. In 1950, when the 81st Congress passed, and President Truman signed into law, a provision authorizing restricted stock options, they were not acting on hasty impulse.

The basic proposals for this kind of reform had been recommended to the Congress 3 years earlier by major professional organizations and by the special tax study committee appointed in 1947 by the Ways and Means Committee of the House of Representatives. This study committee, incidentally, was headed by Roswell Magill, a former Under Secretary of the Treasury (1937–38) and one of the most widely respected authorities on tax law.

These proposals were extensively reviewed in committee hearings, approved by the Ways and Means Committee, and passed by the House before the adjournment of the 80th Congress. The bill incorporating the substance of these proposals and much of their language, which was reintroduced in the 81st Congress, carried the specific recommendation of the American Bar Association.

Hearings and reports on these bills stressed again and again the importance of stock options as incentives. Our experience at Ford—and what we have learned from the top managements of other corporations—confirms the fact that the stock option is effective for two main reasons:

1. It represents an opportunity for gain that is especially sought after, but that will be realized only if the stockholders benefit.
2. It establishes a proprietary interest which alines the executive's personal interests closely with those of stockholders and thus, from their standpoint, affects favorably his day-to-day business actions and decisions. Specifically, it strengthens his interest in the long-term growth and health of the organization.

Now let me point out some important implications of these two points.

[1] E. Manevich, "The Principle of the Personal Incentive and Certain Wage Problems in the U.S.S.R." Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, January 1959, pp. 20–26.

[2] A. Zaytsev and F. Dronov, "Problems of Material Incentives in Government-Owned Enterprises," Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, March 1959, pp. 35–40.

[3] E. Khalfina, "The State Enterprise Under the New Conditions of Industrial Management," Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, May 1959, pp. 39–43.

Inducement for managers

The stock option has a powerful attraction because it offers to the corporate executive his most promising means of building a nest egg. The desire to do so is deep and widespread, reflecting universal human urges for economic security and independence.

At present levels of progressive taxation, it is almost impossible for a top-salaried executive to create a substantial estate out of income. To do so requires that he devote to minimizing taxes and seeking outside capital gains much time and energy that, in the stockholder's views, certainly ought not to be diverted from his job.

Now the desire of the executive to build an estate may be viewed in different ways: (1) as an unworthy, mercenary, greedy sort of thing, or (2) as a way to move people to do constructive things. It is hard to understand what leads some of us to take so grim and puritanical a view of people being normally acquisitive and wanting tangible things (like cars and houses and TV sets) and intangible things (like financial security and independence). Certainly our whole economic system is based on people wanting more and more, and, beyond that, on their being able ultimately to get many of the things they want, granted that these are not the be-all and end-all of life.

The urge to acquire is natural. It exists. And it is very much in the interest of society to see that this urge is used constructively.

Gain for stockholders

From the stockholder's standpoint, the stock option has proved to be an excellent means to take advantage of this urge. It is an opportunity for capital gain that links the fortunes of top executives most directly with those of the stockholders.

As I have suggested, the stock option is far more than a means of getting and keeping the most capable men in, economically, the most critical jobs. Its peculiar effectiveness lies in bringing about a fundamental change in executive attitude. It leads the executive to think and act less as a hired manager or trustee, and more as an owner-manager. I have seen this happen in a hundred and one ways since we instituted a stock option plan at Ford Motor Co. The change in attitude that comes with a proprietary interest—or even with the prospect of eventually earning such an interest—is almost always evident, though it is seldom precisely measurable.

Stock options work.—They work in exactly the way that they are supposed to work. Only those without experience in management, I believe, would argue that management can be made to work as effectively without such incentive.

As far as I am concerned as a stockholder, the goal of Ford Motor Co. is explicit: it is the long-run improvement of profits consistent with the best interest of our stockholders, our employees, our dealers, our suppliers, and the public at large. So long as the executive considers himself a mere hired hand—no matter how able, conscientious, and well-paid a hired hand he may be—his interests, his viewpoint, and his goals may conflict with this basic stockholder objective that should be the guiding objective of all management.

I have mentioned the distractions arising if an executive seeks to create on the outside the nest egg that his job is not providing. There are numerous other temptations for the executive who is only a hired man:

Staff professionalism—the good and necessary desire of staff offices to provide the most excellent professional services—may lead to costly overstaffing.

Paternalism may creep in, leading to inefficient and wasteful practices.

An executive's decisions may be guided by an excessive regard for corporate and, by extension, his own security.

The pursuit of pet projects may be placed ahead of the overriding interests of the business.

Profits and profit growth may be subordinated to spectacular sales results and excessive investment in facilities (empire building).

Certainly there are forms of incentive other than stock options. An awareness of the relationship of employee interest to the company's success may be encouraged by profit-sharing plans, stock purchase plans, and the like. But such plans are a less compelling stimulus than the stock option in focusing attention on the longrun interests of the corporation, as distinguished from short-term results. Furthermore, building a profit-oriented attitude by small, periodic doses is a slow process. In some instances it is desirable to create an immediate stake of appreciable size—a purpose the restricted stock option is admirably suited to serve.

CHARGES OF CRITICS

Let me turn now to those criticisms which, if not always sophisticated or nonpartisan in nature, nevertheless deserve thoughtful examination.

Cost to the public

It is argued that options are unduly costly to the public at large through loss of tax revenues and to stockholders through dilution of their equity.

The argument that a restricted stock option plan is paid by Federal tax subsidy has little, if any, substance. For each dollar of incentive provided in this way, as against a dollar of salary or other compensation, the company is required to give up a tax deduction worth 52 cents. If the optionee sells his stock, he must pay an additional 25 cents in capital-gains tax. In total, then, the Treasury stands to receive 77 cents for each incentive dollar.

This is a high rate of tax return for the Treasury, considering that the top individual tax bracket is 91 percent. True, there may be exceptions in unusual cases, and the optionee can always escape his part of the income tax, although not the estate tax, by holding on to his stock until he dies. But it does not appear that Federal revenues are suffering appreciably on this account or that repeal of these provisions would bring about any significant increase in tax revenues. Furthermore, insofar as stock options generate higher corporate profits for the economy as a whole, they add to the tax base and to Federal revenues.

Cost to stockholders

As for the claim that options are unduly costly to stockholders through dilution of their equity, I know no way of measuring dilution precisely. Certainly I cannot determine exactly the dollars-and-cents cost to our company of the options we have granted, any more than I can count the dollars-and-cents contribution that options have made to the company. Yet I am convinced that the total cost to stockholders has been very small compared to the direct benefit obtained.

The point is, of course, that options cost nothing if the stockholders do not profit. If the stockholders do profit, the cost is minor.

Some critics argue also that option gains are a kind of compensation over and above already generous financial incentives for management. This reasoning is hard to follow. We at Ford have long been concerned about the serious and protracted lag in executive compensation before taxes, when compared with the substantial percentage increases in the compensation of hourly employees and salaried employees below executive rank. Inflation and highly progressive income tax rates have greatly aggravated this situation, which is shared, we have reason to believe, by other large companies. The restricted stock option has been an effective means of meeting this problem.

Motivation

Another criticism often heard is that the proprietary interest of an optionee is reduced if the optionee has to sell a portion of his stock to finance the purchase of another block of option stock. This charge, incidentally, is inconsistent with the suggestion that most optionees are already well off. In the first place, the option itself—even before exercise—provides a strong sense of, and motivation toward, proprietorship. To the extent that the option accrues only over a long period of time, this motivation should and does persist. It has been my observation that Ford optionees who have sold some option stock in order to take up further options have retained sufficient shares to maintain a significant sense of ownership.

Much criticism has been leveled at variable price options. I personally do not approve of variable pricing of options for key employees, but there may be a place for them when used in plans that are more closely akin to purchase of stock by broad groups of employees on an installment payment basis.

Nor do I believe that, in general, the law should permit the repricing of options or the cancellation of existing options so that they can be replaced with options at a lower price. There may, of course, be situations where substitution of lower price options is justified, as in the case of an option price that has been consistently higher than the market price of the stock for a considerable period of time, thus making it worthless as an incentive. But, in the main, such practices are difficult to defend, and specific corrective steps may be in order.

Disclosure of data

It has been charged that there is inadequate disclosure to stockholders of data on option grants and exercises, executives' benefits from options, and sales of optioned shares. The rules and regulations of the Securities and Exchange Commission and the various securities exchanges require listed companies to furnish or make available to the stockholders a good deal of information on options. For example, the rules governing proxies require that these companies include in their proxy materials to stockholders a statement of all options granted since the beginning of the previous year to the directors and officers as a group and to each individual director and each of the three highest paid officers, together with a statement of the market value of the stock when the options were granted. Similar information also must be given about exercises of options by the directors and officers.

In addition, all purchases—including purchases on the exercise of options—and sales of a company's stock by individual directors and officers must be reported by them monthly to the SEC and to a stock exchange. These reports are open for inspection by the public, and many of the transactions described in them are reported in the press.

Rules and regulations aside, however, it is clear that responsible corporate management should give its stockholders information about stock options in sufficient detail to afford an accurate picture, both the manner in which the company is employing options and the number of option grants that have been made. Option data in proxy statements and other reports to stockholders should be in simplified form—generally in tables—and readily understandable. A rule of thumb for management might be simply that the record be made clear and comprehensible.

IMPROVED ADMINISTRATION

There has been much progress in the past decade in administering option plans, in determining their most efficient use, and in detecting and preventing abuses.

As a result of our own experience, Ford Motor Co. has developed policies that we believe are generally sound. We feel such policies can eliminate most of the possible abuses of stock options. Thus—

In our opinion the administration of the option plan should be handled by disinterested directors to insure the protection of the stockholders' interests.

Options should be granted at 100 percent of fair market value.

Except where large grants are necessary to attract a new top executive, options should be granted in relatively small but (when merited) fairly frequent lots.

There should be a relatively long earning-out or accrual period to encourage more sustained effort by optionees for the company's benefit, to lessen the financing problem, and to insure that the optionee continues to merit the option through continued employment.

A sound stock option plan should in no way depend on such things as tax loopholes or provisions of the tax law that would frustrate the intent of Congress or be contrary to basic American principles of fairplay. There undoubtedly are areas in which the tax provisions applying to restricted stock options could be improved. For example, the penalties for unintentional underpricing of options could be modified in the interests of small companies whose stock is not on the market. The provisions relating to the 85 and 95 percent formulas, repricing, and variable price options should also be reexamined.

In any consideration of major tax reform, it is tempting to take sweeping measures designed to simplify and make more orderly the whole tax structure. It is sometimes distressing to tidy minds that the tax system should be used not only to raise revenues but also to provide economic incentives—whether for individuals, by capital gains; for companies, through the fast depreciation write-off; or for the whole economy, by means of proposals to fight recessions by suspending the collection of some taxes for a time. Presumably they want the incentive to be supplied from some other source or by some other means, or they doubt the need of it.

While such feelings are understandable, it seems beyond argument that taxes of the size that we have had and will continue to have must work either as incentives or as disincentives; they cannot be neutral.

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CONCLUSION

I believe that stock options are very much in the public interest. If the detractors of monetary incentives had a sufficient appreciation of the importance of good, soundly motivated management to the real interests of all Americans, I am sure they would become as great supporters of the stock option and other incentive devices as they are now detractors. Unfortunately, many such critics are not well informed on the subject. They do not understand that—

Stock options are in the public interest because they encourage good management.

They encourage business executives to work in ways that are most efficient, most productive, most progressive—and thus contribute most to raising people's incomes and living standards.

Stock options also help our society to put and keep our best managers in positions that have the greatest impact on the whole economy.

Stock options, in short, foster both the most efficient use and the most economical allocation of one of our scarcest and most precious national resources—management. And today, more than ever, it is essential that we do wisely and economically allocate that resource.

These are the social justifications for stock options and for the tax treatment accorded them. The restricted stock option is one of several special provisions of our laws that encourage inventors to invent, entrepreneurs to build new businesses, and professional managers to manage wisely and well. Unless some better means can be found to achieve these ends, we should be careful not to impair the means at hand.

The CHAIRMAN. At the request of Senator Smathers, the Chair places in the record a letter dated December 10, 1963, with accompanying six tables, from the Honorable Douglas Dillon, Secretary of the Treasury, relative to the Treasury's evaluation of the concept of "taxable income after tax."

(The letter and accompanying tables follow:)

TREASURY DEPARTMENT,
Washington, D.C., December 10, 1963.

Hon. GEORGE A. SMATHERS,
U.S. Senate, Washington, D.C.

DEAR SENATOR SMATHERS: This is in reply to your letter in which you ask for Treasury's evaluation of the concept of "taxable income after tax" mentioned during recent Senate Finance Committee hearings with reference to the impact on various incomes of tax reduction under H.R. 8363. In addition, you request comparable "adjusted gross income" data based on incomes from dividends, capital gains, etc., as well as wages and salaries.

Enclosed table 1 illustrates the concept of taxable income after tax for a married couple filing a joint return. The data are those distributed by Senator Gore to the Senate Finance Committee and published as table 2, page 355, part 1, of the hearings on H.R. 8363 before the committee. The data show for taxable income levels, the tax cut and percentage tax cut under H.R. 8363. The table also shows the percentage increase in taxable income after tax. For example, the table shows only a 5.6 percent increase in taxable income after tax for a taxpayer with $4,000 of taxable income, and 18.2 percent increase for a taxpayer with $100,000 of taxable income, and 134.4 percent increase for a taxpayer with $1 million of taxable income. These data are used to demonstrate that the tax bill is unduly favorable to high-income taxpayers.

The assumptions on which this table are based involved several basic errors. The concept of "taxable income after tax" does not afford a meaningful measure of income change in the sense of economic welfare. The concept can deviate considerably from the actual income of taxpayers. For example, two taxpayers may have $10,000 of taxable income yet one may have an actual income of $20,000 and the other actual income of $12,000. Both may receive the same tax reduction under the bill and the percentage change in the taxable income after tax would be the same. But their percentage change in after-tax actual income would differ substantially; tax reduction would represent a far greater increase in after-tax actual income for the $12,000 taxpayer than for the $20,000 person.

The Treasury has based its analysis of the after-tax impact upon "adjusted gross income" plus excluded capital gains which, among available income measures from tax returns, comes closest to actual income. The deduction of tax from adjusted gross income plus excluded capital gains is much more valid than taxable income after tax as a measure of how a tax system affects the relative economic status and welfare of taxpayers.

Moreover, it is fallacious to draw any conclusions from the impact of rate reduction on "taxable income after tax." The example below illustrates this.

Simplified illustration to show the fallacy inherent in the use of taxable income after-tax concept

	Present law	Proposed law
Actual income	$100	$100
Taxable income	$10	$10
Tax rate (flat)(percent)	90	70
Tax	$9	$7
After-tax actual income	$91	[1] $93
After-tax taxable income	$1	[2] $3

[1] $2 increase or 2-percent increase.
[2] $2 increase or 200-percent increase.

The illustration shows the effects of a change in a hypothetical tax law which reduces the flat rate from 90 to 70 percent. It assumes actual income of $100 with the taxpayer taking $90 of deductions to arrive at a taxable income of $10. It is this $10 to which the tax rate applies. The effect of the two laws upon after-tax actual income is to increase the taxpayer's after-tax income by 2 percent. On the other hand, under the concept of taxable income if tax liability is subtracted from taxable income ($10) to arrive at the questionable after-tax taxable income then the 20-point rate reduction shows the taxpayer to be three times better off.

Even when the taxable income after-tax argument is abandoned, it is still contended that H.R. 8363 provides unusually large benefits for high-income taxpayers. It is claimed that the dollar and percentage increase in after-tax income for the upper income groups is much larger than that for other income groups.

H.R. 8363 would provide overall larger dollar and percentage increases for higher income-tax payers. This is due to the progressive nature of the present income tax rates. High income-tax payers pay a much larger percentage of their income in taxes than do low income-tax payers; such income is taxed at higher rates. Consequently, even a reduction in tax liability which is the same percentage for all income groups, will obviously result in larger dollar tax savings for high incomes.

In addition, if the high-income groups have a smaller proportion of their income left after tax prior to rate reduction than low income groups, the high incomes must experience a greater percentage increase in after-tax income after rate reduction.

H.R. 8363 now provides average tax savings of $174. If these dollar savings were given to all taxpayers, marginal rate reduction at the highest incomes which would yield savings of $174 could only result in rate reduction of a small fraction of one point for the top 91 percent rate and this is totally inadequate if incentives to invest and to work are to be stimulated. On the other hand, H.R. 8363 provides balanced and substantial rate reduction for all income groups but still maintains the progressive nature of the income tax. The logic of such a program, however, requires that upper income taxpayers experience a larger dollar and percentage increase in after-tax income than lower income taxpayers.

It is implicitly assumed in the taxable income after tax (table 1 analysis) that all income received is wages and salaries, even at high income levels. However, this assumption is at variance with the facts. Actual tax return data show that the importance of wages and salaries as a source of income is inversely related to the level of income—the higher the income the less important are wages and salaries as a source of income. As incomes increase, capital gains and dividends

become more important. (See table below.) These income sources are subject to rates of taxation that differ from those applicable to wages and salaries.

AGI class	Percent of all returns		Percent of AGI	
	Dividends	Net capital gains	Dividends	Net capital gains
$5,000 to $6,000	5.3	4.0	0.7	0.5
$100,000 to $150,000	93.0	68.4	29.0	16.7
$1,000,000 and over	96.6	86.1	47.1	48.9

Source: 1960 tax returns.

Moreover, there is wide dispersion among taxpayers of capital gains, dividends, and deductions at a given level of high income. Actual tax return data relating ordinary taxable income[1] to adjusted gross income (table 2) provides evidence of such dispersion. The simple hypothetical example below illustrates the questionable use of "averages" where there is wide dispersion.

Number of high-income taxpayers	Percent of AGI	
	Dividends	Net capital gains
1	70	10
1	10	70
2	[1] 40	40

[1] Average.

The same problem exists with reference to "typical" deductions for high income-tax payers.

It is for this reason, the Treasury has not gone about $100,000 of income in examining the tax impact on "typical" taxpayers (tables 3 to 5). Different proportions of wages and salaries, dividends, and capital gains that "typical" taxpayers experience in various income levels up to $100,000 are taken into account. Thus, we estimate that the typical married taxpayer with $100,000 of adjusted gross income has wages and salaries of $66,000, dividends of $21,000, and included capital gains of $13,000.

Table 3 provides for incomes up to $100,000 as employed in tables 4 and 5, the typical breakdown by types of income as between included capital gains, dividends, wages and salaries, and other incomes.

Table 4 reflects the Treasury's measurement of the impact of H.R. 8363 on after-tax AGI plus excluded capital gains. At the $100,000 income level (adjusted gross income) the typical taxpayer would receive a tax cut of $4,295, or 13 percent, and would have an increase in after-tax income of 4 percent. This differs from the $100,000 taxable income taxpayer (wages and salaries) shown in table 1 who would have a tax cut of $8,460, or 16 percent, and an increase in after-tax taxable income of 18 percent. The latter case completely ignores the fact that taxpayers at such level typically have capital gains and dividends and that existing law and H.R. 8363 provide tax treatment for such incomes that differ markedly from the tax treatment of wages and salaries.

As you know, the Treasury is opposed to the basic capital gains provisions in H.R. 8363 which provides for a 40-percent inclusion factor and a 21-percent rate limitation. These are unacceptable as they would provide tax benefits particularly among the wealthy without resolving the related equity problem of capital gains, unrealized at the time of death, that are never subject to income tax. Table 5 illustrates the impact of the House bill on the same taxpayers shown in table 4, except that the taxation of capital gains is based on the present law 50-percent inclusion factor and a 25-percent maximum rate. The $100,000 tax-

[1] After exemptions and itemized deductions, and exclusive of capital gains subject to the alternative tax.

payer would receive $1,049 less tax savings if present law capital gain treatment were continued under H.R. 8363. His tax reduction would be 10 percent instead of 13 percent and his realized income after tax would be increased by 4 percent instead of 5 percent.

The wide divergence of capital gains at high incomes (discussed above) results in substantial disparity of effective rates of taxation at high-income levels. Senator Douglas recently inserted in the Senate Finance Committee hearings on H.R. 8363 tax return statistics prepared by the Treasury that show the wide range of effective tax rates for high incomes. (See pt. 1, pp. 278–282.) Because of the disparity of effective tax rates, these data present a more realistic picture than the Treasury's data for typical taxpayers with $500,000 and $1 million of adjusted gross income. (See Senate Finance Committee hearings, pt. 2, p. 709.) This is why the Treasury prefers to show, as in table 6, the tax results on high income-tax payers for varying assumptions of high, medium, and low capital gains. Table 6 provides tax results under H.R. 8363 and under H.R. 8363 modified to retain present low capital gains tax treatment. Most significantly, the table shows that the capital gains treatment in the House bill would give unjustifiable tax reductions to the taxpayer who already has low effective rates (high proportions of capital gains).

On the other hand, reduction of high marginal rates applicable to ordinary income is justified. Adoption of the Treasury proposal to modify the House bill would permit substantial tax reduction on ordinary income without further reducing taxes on high income-tax payers whose income is mostly capital gains. Actually, at very high-income levels there will be situations where the low effective tax rate will increase, but this arises primarily because of the repeal of the dividend credit. Under present law, a very high income-tax payer whose income comes primarily from capital gain may find that his personal deductions completely wipe out the tax on his ordinary dividend income. He may, nevertheless, take a credit of 4 percent of his dividends against his capital gains tax. The credit is given in this case even though the dividends are not in fact subject to tax. The removal of the credit in this peculiar situation is principally responsible for some tax increases among high income-tax payers under the bill as it would be modified by the Treasury capital gain proposal.

In general, the Treasury proposal to retain present law capital gains treatment will reduce the high effective tax rates related to ordinary income, will retain the present effective tax rates on capital gain income, and thus provide more uniformity of tax treatment, particularly at the high incomes.

Sincerely yours,

DOUGLAS DILLON.

TABLE 1.—*Increase in taxable income after present law tax under the House bill, for selected taxable income levels, 1965—Married couple filing jointly*

Taxable income	Present tax	Tax under House bill	Tax cut	Percent cut in taxes	Percent increase in after-tax taxable income
$1,000	$200	$140	$60	30.0	7.5
$2,000	400	290	110	27.5	6.9
$3,000	600	450	150	25.0	6.3
$4,000	800	620	180	22.5	5.6
$8,000	1,680	1,380	300	17.9	4.7
$12,000	2,720	2,260	460	16.9	5.0
$16,000	3,920	3,260	660	16.8	5.5
$20,000	5,280	4,380	900	17.0	6.1
$28,000	8,520	7,100	1,420	16.7	7.3
$40,000	14,520	12,140	2,380	16.4	9.3
$52,000	21,480	18,060	3,420	15.9	11.2
$76,000	36,720	31,020	5,700	15.5	14.5
$100,000	53,640	45,180	8,460	15.8	18.2
$140,000	84,240	70,380	13,860	16.5	24.9
$200,000	134,640	110,980	23,660	17.6	36.2
$300,000	223,640	180,980	42,660	19.1	55.9
$400,000	313,640	250,980	62,660	20.0	72.6
$600,000	495,640	390,980	104,660	21.1	100.3
$800,000	677,640	530,980	146,660	21.6	119.9
$1,000,000	859,640	670,980	188,660	21.9	134.4

NOTE.—These data were distributed by Senator Gore to the Senate Finance Committee on Oct. 16, 1963 and published in table 2, p. 355, pt. I, of the hearings on H.R. 8363 before the Senate Finance Committee.

Source: Staff of the Joint Committee on Internal Revenue Taaxtion, Oct. 4, 1963.

TABLE 2.—*Dispersion of ordinary taxable income for married taxpayers with adjusted gross income of $500,000 or more, 1961*

Present law rate schedule		Number of taxable returns in bracket with AGI [2] of—	
Ordinary taxable income bracket [1]	Percent marginal rate applicable to bracket	$500,000 to $1,000,000	$1,000,000 and over
Under $4,000	20	16	9
$4,000 to $8,000	22	14	5
$8,000 to $12,000	26	16	6
$12,000 to $16,000	30	18	8
$16,000 to $20,000	34	22	4
$20,000 to $24,000	38	22	10
$24,000 to $28,000	43	18	5
$28,000 to $32,000	47	29	5
$32,000 to $36,000	50	13	9
$36,000 to $40,000	53	16	7
$40,000 to $44,000	56	20	4
$44,000 to $52,000	59	31	11
$52,000 to $64,000	62	46	13
$64,000 to $76,000	65	42	13
$76,000 to $88,000	69	23	12
$88,000 to $100,000	72	22	6
$100,000 to $120,000	75	24	12
$120,000 to $140,000	78	24	8
$140,000 to $160,000	81	16	5
$160,000 to $180,000	84	13	2
$180,000 to $200,000	87	6	1
$200,000 to $300,000	89	65	6
$300,000 to $400,000	90	76	7
$400,000 and over	91	126	55
Returns with capital gains tax only	25	67	56
Returns eligible for 87-percent limitation	87		5
Total		785	284

[1] Highest taxable income bracket in which high income taxpayer falls. Excludes capital gains taxed of alternative rate.
[2] Includes 50 percent of realized net long term capital gains.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Dec. 9, 1963.

TABLE 3.—*Breakdown of AGI of married couple with 2 dependents with typical dividends, capital gains, and other income* [1]

AGI	Wages, salaries, and other income	Dividends included in AGI	Capital gains included in AGI	Percentage of AGI			
				AGI	Wages, salaries, and other income	Dividends included in AGI	Capital gains included in AGI
$3,000	$2,954	$15	$31	100	98.5	0.5	1.0
$4,000	3,953	17	30	100	98.8	.4	.8
$5,000	4,954	20	26	100	99.1	.4	.5
$6,000	5,954	20	26	100	99.2	.4	.4
$7,500	7,430	34	36	100	99.1	.4	.5
$10,000	9,832	82	86	100	98.3	.9	.9
$12,500	12,188	176	136	100	97.5	1.4	1.1
$15,000	14,295	420	285	100	95.3	2.8	1.9
$17,500	16,402	665	433	100	93.7	3.8	2.5
$20,000	18,373	1,014	613	100	91.9	5.1	3.0
$25,000	22,432	1,642	926	100	89.7	6.6	3.7
$30,000	26,191	2,442	1,361	100	87.3	8.2	4.5
$40,000	33,726	4,043	2,231	100	84.3	10.1	5.6
$50,000	41,256	5,643	3,101	100	82.5	11.3	6.2
$75,000	58,030	10,850	6,120	100	77.4	14.5	8.1
$100,000	66,331	20,557	13,112	100	66.3	20.6	13.1

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains are based on 1960 tax return data.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Dec. 9, 1963.

TABLE 4.—*Tax savings and increase in after-tax income under House bill—Married couple with 2 dependents, with typical dividends, capital gains, and other income*[1] *and typical itemized deductions*

Adjusted gross income [1]	Present law		House bill		Tax cut or increase in after-tax income [2]		
	Tax	After-tax income [2]	Tax	After-tax income [2]	Amount	Percentage tax cut	Percentage increase in after-tax income
$3,000	0	$3,131	0	$3,131			
$4,000	$143	3,987	$103	4,027	$40	28	1
$5,000	299	4,827	219	4,907	80	27	2
$6,000	455	5,671	339	5,787	116	26	2
$7,500	719	6,917	569	7,067	150	21	2
$10,000	1,193	8,993	972	9,214	221	19	2
$12,500	1,657	11,079	1,373	11,343	284	17	3
$15,000	2,196	13,189	1,830	13,555	366	17	3
$17,500	2,745	15,288	2,296	15,737	449	16	3
$20,000	3,369	17,344	2,820	17,893	549	16	3
$25,000	4,755	21,271	3,983	22,043	772	16	4
$30,000	6,322	25,139	5,297	26,164	1,025	16	4
$40,000	10,026	32,305	8,392	33,939	1,634	16	5
$50,000	14,254	38,947	12,217	40,984	2,037	14	5
$75,000	23,799	57,421	20,672	60,548	3,127	13	5
$100,000	33,965	79,247	29,670	83,512	4,295	13	5

[1] Includes such income as wages and salaries, interest, rents, business and partnership income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.
[2] After-tax income is after-tax adjusted gross income plus excluded capital gains.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Dec. 9, 1963.

TABLE 5.—*Tax savings and increase in after-tax income under House bill with present capital gains treatment for married couple with two dependents, with typical dividends, capital gains, and other income*[1] *and typical itemized deductions*

Adjusted gross income [1]	Present law		House bill with present capital gains treatment		Tax cut or increase in after-tax income		
	Tax	After-tax income [2]	Tax	After-tax income [2]	Amount	Percentage tax cut	Percentage increase in after-tax income [2]
$3,000	0	$3,131	0	$3,131			
$4,000	$143	3,987	$104	4,026	$39	27	[illegible]
$5,000	299	4,827	220	4,906	79	26	1
$6,000	455	5,671	339	5,787	116	26	2
$7,500	719	6,917	570	7,066	149	21	2
$10,000	1,193	8,993	975	9,211	218	18	2
$12,500	1,657	11,079	1,378	11,358	279	17	3
$15,000	2,196	13,189	1,843	13,542	353	16	3
$17,500	2,745	15,288	2,318	15,717	427	15	3
$20,000	3,369	17,344	2,850	17,863	519	15	3
$25,000	4,755	21,271	4,035	21,991	720	15	3
$30,000	6,322	25,139	5,384	26,097	938	15	4
$40,000	10,026	32,305	8,566	33,765	1,460	16	5
$50,000	14,254	38,947	12,321	40,590	[illegible]33	14	5
$75,000	23,799	57,421	21,162	60,058	[illegible]	11	5
$100,000	33,965	79,257	30,719	82,493	[illegible]	10	4

[1] Includes such income as wages and salaries, interest, rents, business and partn[illegible]ip income, royalties, and typical dividends and capital gains. Estimates of typical dividends and realized capital gains and itemized deductions are based on 1960 tax return data.
[2] After-tax income is after-tax adjusted grossi ncome plus excluded capital gains.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Dec. 9, 1963.

TABLE 6.—*Changes in effective tax rates from present law, under House bill, and under House bill modified by retaining present capital gain provisions, for high-income taxpayers with low, medium, and high proportions of capital gains*

Adjusted gross income	Tax under present law	Tax under House bill [1]	Tax under modified House bill	Tax reduction as percent of present law tax		Tax reduction as percent of realized income after tax	
	Percent of realized income			House bill [1]	Modified House bill	House House bill [1]	Modified House bill
	High proportion of capital gains						
$120,000	27.6	24.2	25.9	12.2	6.3	4.7	2.4
$170,000	25.4	22.4	24.5	11.9	3.6	4.1	1.2
$300,000	22.4	19.6	22.3	12.5	.4	3.6	.1
$700,000	20.1	18.1	21.1	10.4	−4.5	2.6	−1.1
$2,000,000	20.9	18.5	21.3	12.6	−1.9	3.3	−.5
	Medium proportion of capital gains						
$120,000	32.0	28.1	29.1	12.1	8.9	5.8	4.2
$170,000	31.6	27.8	29.2	11.8	7.5	5.4	3.5
$300,000	30.5	27.1	28.9	11.2	5.4	4.9	2.4
$700,000	26.3	23.1	25.4	12.3	3.5	4.4	1.3
$2,000,000	30.2	25.7	28.0	14.9	7.3	6.4	3.2
	Low proportion of capital gains						
$120,000	39.6	34.8	34.9	12.2	12.1	8.0	7.9
$170,000	42.2	37.0	37.2	12.4	11.9	9.0	8.7
$300,000	48.2	41.3	41.6	14.0	13.5	13.0	12.5
$700,000	47.6	39.9	40.6	16.3	14.8	14.8	13.5
$2,000,000	56.7	46.0	46.4	19.0	18.2	24.0	23.1

[1] Assumes that the 40-percent inclusion factor would be applicable to 90 percent of net capital gains.

Note.—Realized income is the adjusted gross income increased by the 50 percent of capital gains excluded in computing adjusted gross income. Realized income does not include tax-exempt interest and the deduction of depletion from gross income.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Dec 9, 1963.

The CHAIRMAN. The Chair places in the record a letter from Mr. Stanley S. Surrey, Assistant Secretary of the Treasury, dated December 6, with further reference to colloquy between Senator Albert Gore and Mr. C. Beverly Briley who testified on section 207 on November 22. The discussion may be found in part 4 of the printed hearings beginning on page 1996.

(The letter accompanying the table from Mr. Surrey follows:)

TREASURY DEPARTMENT,
Washington, D.C., December 6, 1963.

HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During the testimony of Mr. C. Beverly Briley before the committee on November 22, a question was raised as to the impact on the typical taxpayer of section 207 of H.R. 8363.

Section 207 would limit the deductibility of State and local taxes to real and personal property taxes, income taxes, general sales taxes, and taxes incurred in carrying on a trade or business or activities for the production of income. The principal taxes for which a deduction would no longer be allowed are special excise taxes on tobacco, motor fuels, alcoholic beverages, motor vehicle license fees and operators' licenses, and miscellaneous special excise taxes. These taxes represent but a small part of the itemized deduction claimed by the average taxpayer.

In a colloquy between Senator Gore and Mr. Briley, it was indicated that the typical taxpayer in Tennessee would be denied $240 of his present itemized deductions, of which $175 would be attributable to the gasoline tax. It was further indicated that, as a result, the typical taxpayer in Tennessee would lose more than he would gain from the tax bill. Our data shows the impact of section 207 would be far less than indicated by Mr. Briley and that virtually all taxpayers would pay lower taxes as a result of section 207, coupled with the rate reductions. I therefore request that this letter and the attached table be inserted in the record in order to clarify this point.

The Bureau of Public Roads of the Commerce Department reported that in 1961 the average private automobile was driven 9,465 miles a year and consumed 658 gallons of gasoline at a rate of 14.38 miles to a gallon. In the case of a typical taxpayer who pays a State gasoline tax of 7 cents per gallon (as in Tennessee) for 658 galons, the total gasoline tax would then be about $46 per year, rather than the $175 mentioned by Mr. Briley. Even a taxpayer who drove 15,000 miles per year—more than one-and-one-half times the national average—would pay only about $70 in gasoline taxes. Table 1 attached shows, for taxpayers in selected income brackets who drive from 5,000 to 15,000 miles per year, the amount of State gasoline taxes paid and the tax saving resulting therefrom. As may be seen in table 1, the loss of a deduction for gasoline taxes for a typical married taxpayer with $4,000 to $8,000 of taxable income would result in a reduction of tax savings of $8.87.

Using the figures suggested by Mr. Briley in his testimony for the taxes other than gasoline taxes for which a deduction would no longer be allowed, the typical taxpayer who pays $46 of gasoline tax per year would lose tax deductions under section 207 amounting to $111 (rather than $240). The tax savings that result from deductions of $111 would range from $15.54, for a taxpayer in the 14 percent tax bracket, to $77.70 for a taxpayer in the 70 percent tax bracket. In every case the amount of lost tax saving is far overshadowed by the tax savings that would result from the rate reductions also provided by H.R. 8363.

Sincerely yours,

STANLEY S. SURREY, *Assistant Secretary.*

TABLE 1.—*State gasoline taxes paid and amount of reduction of tax savings by disallowing deduction of gasoline tax under H.R. 8363, for married taxpayers in selected income brackets*

	Mileage per annum		
	5,000 miles	10,000 miles (approximates national average)	15,000 miles
Total State gasoline taxes paid	$23.33	$46.66	$70.00
Selected taxable income brackets (joint returns):			
$2,000 to $3,000	3.73	7.47	11.20
$3,000 to $4,000	3.97	7.93	11.90
$4,000 to $8,000	4.43	8.87	13.30
$8,000 to $12,000	5.13	10.27	15.40
$12,000 to $16,000	5.83	11.66	17.50
$24,000 to $28,000	8.40	16.80	25.20
$32,000 to $36,000	9.80	19.60	29.40
$52,000 to $64,000	12.36	24.73	37.10
$100,000 to $120,000	14.46	28.93	43.40

NOTE.—U.S. Bureau of Public Roads reported in BPR 62-51, Dec. 7, 1962, that the average passenger car (business and nonbusiness) traveled 9,465 miles in 1961 and consumed 658 gallons of fuel, at a rate of 14.38 miles per gallon. The table assumes for simplicity that the rate of fuel consumption is 15 miles per gallon. The table also assumes State gasoline tax is 7 cents per gallon.

The CHAIRMAN. Our first witness is Mr. V. Henry Rothschild 2d, of Piermont, N.Y.

Please proceed, Mr. Rothschild.

STATEMENT OF V. HENRY ROTHSCHILD 2D, PIERMONT, N.Y.

Mr. ROTHSCHILD. Mr. Chairman, distinguished members of the committee, I am grateful for this opportunity of appearing before you in connection with the stock option and stock purchase sections of the tax bill.

QUALIFICATIONS

My name is V. Henry Rothschild, and I reside in the village of Piermont, county of Rockland, State of New York. I am an attorney with offices in New York City and my work for many years has been chiefly with executive and employee compensation plans and practices. I am coauthor of a standard two-volume treatise on executive compensation, the third edition of which, published last year, devotes more than 100 pages to an intensive study of stock option and stock purchase plans and practices. I have lectured before bar associations and other organizations and groups throughout the United States and I have been a visiting lecturer at law schools. I am a lecturer for the Practicing Law Institute and the New York University Institute on Federal Taxation. During the Korean conflict, I served as Chief Counsel and later as Vice Chairman of the Salary Stabilization Board, in which capacity I reviewed stock plans and practices of companies throughout the country. On returning to private practice, I took part in drafting State legislation and regulations relating to stock option plans. Because of my experience with and academic study of stock options, I serve as an informal clearinghouse of information for both proponents and opponents of stock options; and a number of individuals who have appeared or taken a position in hearings before this committee or before the House Ways and Means Committee, have discussed their views with me.

VIEWPOINT

I appear here entirely on my own initiative following correspondence as a result of a speech some time ago in which I mentioned the need for stock option reform. Senator Gore was so generous as to arrange for me to appear even though he knows that I am not fully in agreement with his views. However, I wish to stress my convictions that this committee did an outstanding service in its hearings in 1961 on Senator Gore's bill, S. 1625. These hearings brought out undoubted abuses and led to the proposed corrective legislation now before the committee for consideration.

Shortly after enactment of the 1954 code, I called attention to abuses made possible by the statutory amendments in the tax treatment of stock options adopted as part of the Internal Revenue Code of 1954. In a speech in January 1955 before the National Industrial Conference Board, I criticized, in particular, provisions permitting the option price to be reduced after an option had been granted and provisions permitting stock options to be granted to substantial stockholders.[1] Two years later the Harvard Business Review published an article of mine in which I called attention to the defeat of stock option purposes through sales of option stock.[2] In short, my bias is that of a

[1] "Executive Compensation under the 1954 Revenue Code," reprinted in the Commercial and Financial Chronicle, Mar. 31, 1955.
[2] "Financing Stock Purchases by Executives," Harvard Business Review (March–April 1957, at p. 136).

management consultant on employee benefit plans vitally interested in the existence of adequate incentives and, therefore, deeply concerned about the proper administration of incentive plans.

CONTROVERSIAL NATURE OF STOCK OPTIONS

Executive compensation and incentives are a controversial subject. We approve fabulous pay for our motion picture stars, our baseball heroes, our prize fighters,[3] and we accept the fortunes amassed by those with capital, but our hackles rise when we hear of high rewards for management who frequently have no capital other than executive ability. Yet the fortunes of our country and its position in the world are almost as dependent on the leadership of our business enterprises as on the President and Members of the Senate and House of Representatives. And the very fact that the pay of the President and of Members of Congress, which derives from public funds, is an inadaquate reflection of the value of the public service they render in turn leads to an unfavorable viewpoint toward the pay of executives, which derives from business profits.

Arrangements made by a company for the purchase of its stock provide almost the sole method by which executives can create an estate of any size today. Accordingly, these arrangements are in a particularly sensitive area. I suggest that criticism of any particular arrangement must be viewed against the backdrop of our critical attitude of executive compensation generally.

A number of high-minded individuals who have criticized the stock option, including witnesses who have testified before this committee, are frankly on record in opposition to any substantial compensation for executives. Thus, one witness expressed his view that a man who reaches the top has, by the very act of doing so, demonstrated that he needs no additional incentive; this witness has suggested in a thought-provoking book that the prestige, power, and nonfinancial emoluments of high office make monetary benefits unnecessary.[4] Another witness is strongly in favor of dollar ceilings upon salaries and compensation generally.[5] Those who hold such views will naturally oppose the stock option as wholly unnecessary. I think most of us still agree, however, that financial incentives are the basic moving force in our society, and I say that a ceiling on what a man can earn is no more consistent with our system than a ceiling on dividends, interest, rent, or other income.

So much has been written and said recently on the subject of stock options that I shall confine my remarks to a few significant points that I think have, perhaps, not been sufficiently emphasized.

OPTIONS INVOLVE CAPITAL APPRECIATION

It is frequently said that the exercise of a stock option results in compensation measured by the spread between the option price and

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[3] "As a people we are rather proud of the high salaries paid to prominent movie stars, athletes, and others, but in the business world there are social, economic, and political pressures which fail to credit the individual skills and capabilities required of business leaders," Rosensteel, "New Study Shows Executive Trends," Nation's Business (June 1956).

[4] Livingston, "The American Stockholder," 225, ff. passim (1958).

[5] See, e.g., the resolution proposed by Lewis D. Gilbert with others at annual meeting of shareholders of Radio Corp. of America held on May 7, 1963, set forth at p. 8 of the proxy statement for the meeting.

the market value of the option stock at the time of exercise of the option. Now if the spread on exercise of an option actually constitutes compensation, there would surely be good reason for taxing it in the same way and at the same rates as salary and wages. But the fact of the matter is that a stock option granted to an employee involves two separate elements. The option, if granted in consideration of services, involves compensation, surely. However, we overlook that it is the option itself which is the compensation and not what later happens to the stock subject to the option. To the extent that the stock increases in value after the option to buy it has been granted, capital appreciation has taken place which ought not to be confused with compensation.

Let us take, as an example, options granted by the X company to employees A, B, and C, each on the same day, each for a 5-year term, each covering 100 shares at a price of $100 a share, which we shall assume was the fair market value of the stock subject to the options at the time they were granted, and each of them otherwise identical in terms and conditions. One year later, employee A exercises his option on a day when the stock is selling at $110 a share. Employee B exercises his option a few days later when the stock has gone up to $112 a share. Can it be said that employees A and B each received a different amount of compensation because of the difference in market price on the date each exercised an identical option? Now let us assume that employee C waits another year, and when he exercises his option, the stock is back to $100 a share. Does this mean that, as distinguished from employees A and B, employee C received no compensation from his identical option, because there was no spread between market value and option price at the time of his exercise? I submit that, to the extent that three identical options granted A, B, and C involve compensation, the amount was exactly the same.

But if these options involve compensation, how is such compensation to be measured and taxed? When an option takes the form of a fully transferable right or warrant to purchase stock without restrictions or conditions of any kind, the employee receives something of immediate and measurable value. This value should be taxed forthwith as compensation and the courts have so held.[6] However, in the usual case, the right or option to purchase stock is personal to the employee, nontransferable and subject to conditions such as continued employment. The value of the option is then difficult, if not impossible, to determine on any objective basis. With the restrictions usually attached to the restricted stock option, the option itself at the time it is granted may have little, if any, value under any reasonable standard. This is the justification for ignoring the element of compensation involved in a restricted stock option and in taxing the entire gain realized through an option on the same basis as any other capital appreciation. Of course, the option can become of substantial value as the stock subject to option increases in price, but by the same token the option confers no benefit whatever if the option stock fails to increase in value.

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[6] *Com'r* v. *Estate of Lauson Stone*, 210 F. 2d 33 (3d Cir. 1954); *McNamara* v. *Com'r*, 210 F. 2d 505 (7th Cir. 1954).

CODE NOT INTENDED TO CONFER NEW TREATMENT ON STOCK OPTIONS

A second point which I think may not have been given sufficient consideration stems from the history of stock options. The provisions of the code relating to stock options are sometimes attacked as conferring preferential treatment "without decent justification."[7] The fact of the matter is, that the pertinent provisions of the code, which were first enacted in 1950, were not intended to represent a new tax treatment of stock options at all. Rather, the Revenue Act of 1950 was intended to restore the law to the substance of what it was generally thought to have been for many, many years.

Stock options are an old and time-honored incentive to management. They go back at least to the 1920's and were popular in the 1930's when small, weak, or distressed companies found in the stock option their only means to attract good management.[8] Several of our important companies can be said to owe their continued existence in some part to management attracted or retained by the promise of stock options—among them, the National Cash Register Co., Remington Rand, and Valspar. In more recent times, there is, of course, the dramatic case of Ford Motor Co.

The Treasury's effort to tax stock options as compensation under a 1923 regulation was so frequently defeated in the courts that in 1939 the Treasury finally acquiesced in nontaxability. It was not until 1946, following the decision of the U.S. Supreme Court in the *Smith* case,[9] that the Treasury again sought to tax stock options under regulations which were challenged as being far broader than warranted by either the *Smith* case or any other authority. Thus, the present code provisions, which were directed at the 1946 Treasury Regulations,[10] were not designed to confer new benefits or to represent a substantial departure from the prior tax law but, rather, were intended to restore the substance of tax treatment to what people thought it had been for almost 20 years—and the restoration was by no means complete, since it applied only to a limited or restricted type of option.

During the period from 1946 to 1950 when the Treasury, armed with the *Smith* case, sought to tax all options as compensation, with the tax based on the spread between market value and option price on exercise, options fell into disuse. Here is evidence of what I think is indisputable; namely, that a tax on stock options based on paper profit at time of exercise would, in effect, abolish the option. To require a tax to be paid on a paper profit means that stock subject to option may have to be sold to pay the tax, with the purpose of encouraging holding of the stock thereby frustrated.

NEEDED AMENDMENTS OF THE LAW

I submit that the abuses which have arisen in recent years do not call for so drastic a result as the abolition of the option. I think that some companies have overused the option, substituting the option

[7] Griswold, "The Mysterious Stock Option," Committee on Ways and Means, 2 Tax Revision Compendium, at p. 1327.

[8] John C. Baker, "Stock Options for Executives," 29 Harvard Business Review, vol. 20, p. 106 (1940) (26 to 35 percent of listed companies adopted stock option plans between 1928 and 1938).

[9] 324 U.S. 177, 65 Sup. Ct. 591 (1945).

[10] 81st Cong., 2d sess., S. Rept. 2375 (Aug. 22, 1950).

for incentives, such as salary, bonus, and profit sharing. But if, as is conceded, there is no tax loss, overuse in itself does not call for corective tax legislation. On the basis of as objective and fairminded an appraisal as possible, I believe that the following are the chief practices that call for legislative correction:

1. Resetting the option price: By amendment adopted in 1954, the option price under an existing option can, generally speaking, be reduced without adverse tax consequences if there is an average decline over a 12-month period of 20 percent or more in the market value of stock subject to option. More than any other, the use of this provision has been severely and, I think, properly criticized. There is much to be said for allowing management to participate in increased values to stockholders which management's efforts may have helped to create. The entire concept is changed, however, when the option price can later be reduced and the executive can thus benefit whether the stock goes up or down. The House bill rightly seeks to eliminate this authority.

However, what appears to be a loophole has been created which could enable new options to be granted at lower option prices to those with outstanding options. Moreover, in prohibiting exercise of a qualified option while another option is outstanding, even though not yet exercisable—the so-called first-in and first-out rule—the bill goes a good deal further than necessary and would, in effect, preclude both a usual practice of annual grants of options and the individual grant of a new option to an executive who is promoted or otherwise entitled to a new option. This could have the unsalutary effect of encouraging the grant of options covering more shares than would otherwise have been covered, since an option once granted could foreclose the grant of another. I suggest that to accomplish the intended purpose of precluding the grant of a new option at a lower price, the bill provide just that—that is, that no qualified option could be exercised while an existing option carrying a higher option price is exercisable. To close loopholes, the bill should specifically preclude either the termination or the amendment of an existing option for the purpose of granting a new option at a lower price.

2. Variable price options: A variable price option is one which fixes the option price in terms of a percentage of market price at some time other than the time when the option is granted. For example, an option may give an executive the right to buy so many shares of his company's stock over the next 5 years at a price equal to 85 percent of the market value of the stock at the time he exercises the option. This clause can operate like the reset clause in providing an incentive to bring about a low price for the stock. The clause appears to have been adopted with the American Telephone & Telegraph stock purchase plan in mind. The House bill properly eliminates this provision for the future and makes separate provision for the A.T. & T. type of plan.

3. Sales of option stock: Another major criticism of stock option plans has resulted from sales of option stock which defeat the purpose of encouraging stock ownership. The present holding requirements in the code are that the stock must be held for 6 months after the option has been exercised and may not be sold within 2 years from the time the option was granted. To prevent short-term sales of

option stock, a number of companies have expressly required that stock be held for a minimum period after it has been acquired upon exercise of options. Other companies have simply made it clear that sales of option stock without good cause will be viewed with disapproval. Generally speaking, the holding record for option shares has been good, and I would venture to say that, as the result of stock options management today owns far more company stock than at any time since the days when capital and management were one.

It sometimes becomes necessary, as the result of illness or emergency, for an employee to sell stock which he had intended to hold, and in the plans with holding requirements which I have drafted, I have made an exception for such sales if approved by an independent committee. An exception of this kind, however, may not be practical in a statute. I favor the House bill requirement for retention of option shares, but with a reduction in the holding period to 2 years to conform both with industry practice and other holding periods in the tax bill.

4. Major stockholders: The 1954 code extended tax benefits to certain stock options granted substantial stockholders. The declared purposes of the stock option statute are "to encourage incentive devices by corporations who wish to attract new management, convert their officers into 'partners' by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation."[11] The 1954 amendments granting stock option benefits to stockholders owning over 10 percent of the company's stock are not in keeping with the declared purposes of the tax statute and are, in my opinion, properly eliminated by the House bill.

5. Elimination of discount: The code now confers tax benefits on options with an option price as low as 85 percent of fair market value at the time the option is granted. The discount was intended to give leeway to the closely held company whose stock is difficult to value. Among publicly held companies, there is a trend today to fix the option price at no less than 100 percent of fair market value at the time the option is granted, except in the case of option or purchase plans for employees below the level of top management. The House bill makes separate provision for a discount in the case of stock purchase plans and also provides for the closely held company as hereafter mentioned. The requirement of an option price of 100 percent of fair market value to qualify for full tax benefits is in my view entirely proper.

6. The small or closely held company: Critics of the stock option argue that it is the small or closely held company which needs the stock option the most and yet it has been the closely held company which has difficulty in making use of it. The problem of valuing its stock makes it difficult for the closely held company to qualify an option for tax benefits, since the code at present disqualifies entirely any option if the option price falls below 85 percent of fair market value. The problem is alleviated in the House bill, which taxes as compensation (*a*) 150 percent of the spread between market value and option price at the time the option is granted, or (*b*) 100 percent of the spread at the time the option is exercised, whichever is the lower.

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[11] See report cited in footnote 10.

However, there are several objections to the way the bill handles this matter. In the first place, the bill requires that an attempt be made to fix the option at fair market value "in good faith." A company may think it has fixed an option price in good faith but the Treasury may not, and by adding this specific requirement of good faith, there is preserved the existing uncertainty for small companies which has been so much criticized.

I would suggest that the specific requirement of good faith be eliminated and that, instead, a greater penalty be imposed when there is substantial undervaluation. For example, if the option price is found to be less than 85 percent, the tax could be on 200 percent of the difference or spread, or on the part thereof under 85 percent. I also submit that the tax should be payable on sale of the stock rather than on exercise of the option. Shares of stock of closely held companies are usually not readily marketable and on exercise the employee might thus have no means of paying the tax. If the employee does not sell, the tax could be payable on death, as in the case of the proposed tax on the spread in the case of options granted under employee stock purchase plans.

7. Term of option: The code provisions adopted in 1950 did not limit the term of an option qualifying for tax benefits. The present 10-year term, which followed a requirement formerly imposed by the New York Stock Exchange, was imposed in 1954. The reduction of the term to 5 years will somewhat impair the usefulness of options under plans such as those of General Motors and Du Pont, whose options are part of long-range bonus plans and in some measure intended as an alternative to retirement pay. Nevertheless, I think a reduction in the option term is warranted and suggest as a compromise the 7-year term found appropriate by a number of companies.

I do urge, however, that options granted for a longer term prior to the date of enactment of this tax legislation not be retroactively disqualified. The 1954 code specifically excepted from the operation of the 10-year limitation options granted prior to the date of the legislation, and I urge that the committee consider a similar provision if it recommends a reduction of the option term.

8. Stockholder approval: The House bill requires that to qualify for tax benefits a stock option must be granted under a plan which has been approved by stockholders. As matter of practice, must companies today seek stockholder approval for a plan under which options are to be granted to management, and stockholder approval is required by certain stock exchanges, including the New York Stock Exchange, except in the case of an option granted to a new employee and in the case of options granted to lower level employees generally. Moreover, stockholder approval is required today as a corporate matter by legislation in a number of States. The requirement of stockholder approval in the House bill is, in principle, to be commended, with an exception which can give rise to trouble.

The bill requires the plan to designate the employees (or class of employees) to whom options are to be granted. Most plans designate eligible employees in general terms; for example, by simply describing those eligible as "key employees." It is not clear whether such a designation would meet the House bill's requirement, and I would suggest that if, as I understand, the provision is aimed at disclosure, it

be clarified and expanded to require a plan approved by stockholders to state whether officers and directors are eligible and, if so, the maximum amounts that may be granted to them individually or in the aggregate.

9. Stock purchase plans: The House bill provides tax benefits for stock purchase plans under which an employee can purchase shares of his company's stock at a discount not to exceed 15 percent of the market value of the stock at the time either subscribed for or paid for, whichever is lower. This provision is intended to retain the tax benefits incident to plans such as that of American Telephone & Telegraph Co. To qualify for these benefits, the bill would require the plan to be offered to all employees on a nondiscriminatory basis.

A nondiscrimination clause is fair and proper, but the way the clause is drafted in the House bill could disqualify many plans; even that of the American Telephone & Telegraph Co. The bill requires that a plan must be offered to all employees. But the laws of some foreign countries make it impractical, if not impossible, for stock to be offered to employees who are subject to the laws of such countries; and such employees are usually not offered a stock purchase plan. With regard to employees resident in the United States, one of several unions may take the position that it does do not want the plan offered to its employees, and a single union could thus have a veto over the use of the plan for all employees.

The bill only requires that all employees of a corporation be eligible, and problems such as those suggested might, perhaps, be met by putting such employees on the payroll of a subsidiary none of whose employees would be offered the plan. But why should such a device be necessary?

With regard to nondiscrimination, I think the bill should simply require that the plan follow a reasonable classification and not discriminate in favor of officers, shareholders, and highly paid employees. The precedent for this provision is a similar provision in the new entertainment expense law adopted last year (IRC sec. 274(c)(5)).

The only other serious problem which I see in the stock purchase section is that which limits to 27 months the period of an option to purchase, unless the option price is at least 85 percent of market value at the time of exercise, when the option term may be up to 5 years. A number of sound plans gear option price to market value at the time the option is granted, and do not provide for a reduction in price if market value is later lower. Why should these plans, which are less favorable to employees, be denied a 5-year term?

10. Retroactivity: The House bill makes its provisions generally applicable to stock options granted and stock purchase arrangements effected after June 11, 1963. June 11, 1963, was the date as of which the House Ways and Means Committee had announced changes it proposed to make in the tax law. However, the bill as approved by the committee on September 10, 1963, contains a number of changes not theretofore announced. In accordance with the very proper reluctance of Congress to avoid retroactive legislation, I urge that this new tax legislation take effect as of the date of its enactment. At the very least, the legislation should authorize, without penalty, conforming changes in options granted and arrangements made before the legislation takes effect.

SUMMARY AND CONCLUSIONS

Stock options are fundamental to our system of enterprise. Valid criticism of some practices that have taken place is in large part met by provisions of the bill passed by the House.

Subject to few changes, I favor the House bill as a well-considered measure meeting most questioned practices. The changes that I recommend to the committee are the following:

1. The House bill properly eliminates the "reset" clause and the variable price option, both of which, in effect, permit a lower option price than an option price at the time the option has been granted. However, the first-in, first-out clause, as drafted, may both open loopholes and affect proper business practices in the granting of options. I suggest that this clause should be redrafted (*a*) so as to preclude the exercise of a new option only when a preexisting option is subject to exercise, and (*b*) so as specifically to prevent any change or termination of a preexisting option for the purpose of granting a more favorable option.

2. I favor elimination of any discount in the option price from fair market value at the time the option is granted. However, the requirement of good faith in fixing market value continues existing uncertainty for the closely held company and the smaller company whose stock is not widely traded, for which there is general agreement as to the desirability of making stock options available. The "good faith" clause should be eliminated and, instead, there should be greater penalties for substantial undervaluation; such penalties should be payable on sale of the option stock, or on death of the employee if the stock is not sold during his lifetime, instead of on exercise of the option, when funds are not available to pay the tax except through sale of the stock.

3. The holding period for stock acquired upon exercise of an option should be increased from the present 6-month period, but I suggest a 2-year rather than a 3-year period as more in keeping with conservative business practices and with other holding periods in the tax bill.

4. If the term of an option is to be reduced from 10 years, I suggest that it be reduced not to 5 years but to the 7-year term which many companies have adopted.

5. I favor a requirement that the option plan be submitted to stockholders for approval, but suggest that there is ambiguity in the House bill requirement that the plan designate the employees or "class of employees" who will be eligible under the plan. Instead, I suggest that the plan be required to state whether officers and directors are eligible and, if so, the maximum number of shares that may be allocated to them under their options.

6. A company should be permitted to offer its stock under a qualified stock purchase plan to a general classification of employees, provided the classification does not discriminate in favor of officers, directors, shareholders, or highly paid employees.

7. The term of an option to purchase under an employees' stock purchase plan offered to employees generally should be 5 years when the option price is based upon market value at the time the plan is offered to employees, as well as when the option price is based on the market value at the time the option is exercised.

8. Finally, and most important, the tax bill should not be retroactive, and a company should be permitted to amend existing stock option and purchase arrangements to conform without penalty to the law as enacted.

(The appendix to Mr. Rothschild's statement follows:)

COMMENT ON MAJOR CRITICISM OF STOCK OPTIONS

Criticism of stock options which I believe justified, such as reducing the option price after the option has been granted, the grant of options at a discount, and the grant of options to substantial stockholders, is discussed in the text of my statement. This appendix comments on other criticisms of stock options.

1. "*Magnitude of benefits.*"—Stock options have created very substantial benefits, estates of large size, millionaires.

Comment: This criticism is usually voiced by those who believe that there should be a ceiling on salaries and compensation. A stock option creates no benefits unless the stock subject to option increases in value, when all stockholders benefit. That all stockholders have substantial benefit through increases in value of their stock has not led and should not lead to their being subject to a penalty tax. Surely, we have not reached a point where it is considered an evil thing for an individual to become a millionaire.

2. "*Preferential treatment.*"—Stock options involve preferential treatment in that the spread upon exercise of an option between the option price and fair market value of the stock subject to option constitutes compensation which should be taxed immediately in the same way and at the same rates as salaries and wages.

Comment: The spread between fair market value and option price, to the extent that it represents an increase in value of the option stock from the date of the option grant, constitutes capital appreciation, which should be taxed in the same way and at the same rates as capital appreciation generally. This point is discussed in the text of the accompanying statement.

3. *Stock option rewards are based on investor outlook, not the results of good management.*—The benefits received from an option are based on market values which reflect investor outlook, rather than on company profits for which management is responsible.

Comment: The benefits received by stockholders at large are likewise based on market prices, and the criticism goes to the factors which fix market price. When the market price of a company's stock rises notwithstanding a decline in profits, the expected future must be responsible, and at least one important factor influencing that expected future must be the market's appraisal of the company's management and future earnings as a result of management.

4. *Stock options dilute outstanding stock.*—Stock options are costly to the company and to stockholders and dilute the value of the company's stock.

Comment: This subject is admittedly a technical and difficult one. However, the following point of view calls for consideration when it is said that options result in dilution.

If a company sells its stock to the public at fair market value, there should be no dilution of outstanding stock, for the capital received should be equivalent to the value of the stock previously outstanding; in seeking new capital, the company makes clear its view that the additional dividends that it will have to pay will be less than the amount that it will earn on the new capital. If the company, instead of receiving full payment, accepts a subscription or commitment to purchase such shares, there is similarly no dilution but simply a loss of the use of the purchase price until the purchase price has been fully paid. The difference between these two transactions and an option to purchase at fair market value when the option is granted is that, in the case of an option, the company may not need additional capital and there is no commitment to purchase unless and until the option is exercised. If the company needs additional capital and issues new shares if and when the option is exercised, there is no more dilution than in the case of a purchase or subscription to purchase. The fact that the company could, at the time the option is exercised, have sold its stock for more than the option price should no more be considered a cost to the company than it would be under a purchase or subscription arrangement. If a company which grants an option to buy shares of its stock at its then fair market value covers the option by buying and holding an equivalent number of shares at the same price, can it be said that there is dilution of outstanding

stock. The only cost is the loss of the use of the money represented by the cost to the company of the stock that it has purchased to cover the option and, pending exercise of the option, more earnings will be available for outstanding stock since no dividends will be paid on the treasury shares held by the company.

5. *Competitive use of options.*—Many companies are forced to grant options because their competitors do so. Removal of tax benefits would eliminate the need to grant options.

Comment: Removal of tax benefits would harm the smaller company and the company in distress and favor the larger, more successful companies which can afford higher salaries and pensions and provide greater security. The smaller company can often offer only the prospect of future gains through stock opportunities.

6. *Options do not accomplish incentive purposes.*—Companies which have not granted options have a better record than those which have granted options.

Comment: There is no reliable way of judging the effectiveness of options in improving company earnings. Some companies which have granted options have done better than others, but there is no evidence that such companies would not have done as well without options. By the same token, there is no reliable evidence that companies which did not do well with options would not have done worse without an option program.

7. *Use of options for present management.*—Options have been used more extensively for existing management, including older executives, than to attract new management.

Comment: A sound option program will exclude executives who have reached a designated age—for example, 60 or 61—in the absence of good cause. Such cause may be found in the need to retain the services of a key executive who would otherwise retire.

8. *Options are discriminatory.*—Options have generally been confined to top management.

Comment: So have high salaries, substantial bonuses and other inducements to those responsible for the company's profits and future.

9. *Options are an inefficient method of compensation.*—According to the Treasury Department, options have been granted to employees with relatively low earnings and such employees would benefit more from salary increases which the company could grant without additional cost since such increases would be tax deductible.

Comment: The Treasury argument seems inconsistent with the criticism that options are confined to the most highly paid. It overlooks the point that the function of an option is not to give the employee benefits unless and until stockholders have benefited through an increase in price of the company's stock.

10. *Misleading financial statements.*—As a reason for repeal of tax benefits accorded options, the Treasury Department declares that options are not properly reflected in the profit and loss and balance sheet statements of companies which grant them.

Comment: The proper treatment of stock options on a company's financial statement has been extensively considered by the American Institute of Certified Public Accountants and is the subject of regulation by the Securities and Exchange Commission.

The CHAIRMAN. Thank you, Mr. Rothschild.

Any questions?

The chairman is very proud to present to the committee today a distinguished Virginian, Mr. Lewis L. Strauss.

Mr. Strauss, of course, needs no introduction to the committee. He is well known and highly respected not only in the business community but also in Government. His fine public contributions to the country started more than 45 years ago in 1917. He has been recognized by five Presidents: Wilson, Hoover, Roosevelt, Truman, and Eisenhower. His most recent service was as Chairman of the Atomic Energy Commission and in the capacity of Secretary of Commerce.

Admiral Strauss, the committee welcomes you and looks forward to hearing from you on the pending bill at this time.

Mr. STRAUSS. Thank you, Mr. Chairman.

The CHAIRMAN. Take a seat, sir, and proceed.

STATEMENT OF ADM. LEWIS STRAUSS (RETIRED), WASHINGTON, D.C.

Mr. STRAUSS. Thank you, Senator Byrd. I have a brief statement which, with your permission, I will read.

The CHAIRMAN. Proceed.

Mr. STRAUSS. Mr. Chairman and gentlemen, it is an honor to be invited to testify before this distinguished committee while you are occupied with legislation to amend the Internal Revenue Code by the reduction of individual and corporate income taxes. Most Americans feel expert on the subject of taxation and I think I am no exception.

During the past 50 years, I have been engaged in industry, in banking, and more recently in military and civilian public service. In the first two capacities, I was privileged to be a substantial taxpayer. In public service, on the other hand, I had the responsibility for spending many of the billions of tax dollars collected from you and me and the general public. In consequence, I have a somewhat unusual, though not unique, view of the Federal economy. These experiences have resulted in some conclusions which I will try to lay before you very briefly. It will be necessary to state one or two facts and figures which are well known to you, and I apologize for that in advance.

Your study, of course, is not limited to consideration of tax brackets. Your decisions about taxation will affect our international credit, our balance of payments, the future purchasing power of the dollar, the level of employment of our people, and many other aspects of our economic life. It is certainly one of the most important and sensitive issues confronting the Congress and, for that reason, I believe the American people most probably are happy that you have approached your decision unhurriedly. A hasty and perhaps wrong conclusion will not be easily undone, nor its undoing even attempted before much harm will have resulted.

Taxes are a necessary evil and properly subject to constructive criticism when they are too high—when the schedules which produced them become too complicated—and when they are inequitable, favoring one group of taxpayers as against another.

All these conditions presently prevail, and tax reform is as urgently needed as tax reduction. The crazy-quilt pattern of taxation which grew up when taxes were low probably hinders our economic growth as much as any other single thing.

Though comprehensive tax reform is not attempted in the measure now before you, the best time to achieve procedural tax reform would seem to be when taxes are being lowered, and there has been no time so favorable in the 50-year history of the Federal income tax.

It might well be that tax reform would contribute a more lasting stimulus to economic health that a tax cut, if only for the reason that tax reform itself would be likely to be more enduring.

For the present, one assumes that tax reform is excluded from your consideration, beyond the minor changes which H.R. 8363 comprises.

Happily, we have moved away from the era when income taxes were to be used to effect a redistribution of wealth and have returned to the principle that they are primarily the instrument for raising the revenues which defray the cost of government—but currently a new

theory has been added. This is the doctrine that taxes may be managed, together with deficit financing, to promote economic growth. This is presently no more than a theory totally without proof, but there are many economists who regard it as reliable as revealed truth.

Many who have counseled our Government in the past did not believe it. You will remember the advice of our first President in his farewell address to the Congress where he said this:

> As a very important source of strength and security cherish public credit * * * avoiding likewise the accumulation of debt, not only by shunning occasions of expense, but by vigorous exercise in time of peace to discharge the debts which unavoidable wars may have occasioned * * *.

These principles were still viable 160 years later, when a respected witness of recent years before your committee, Mr. Bernard Baruch, testified as follows:

> In the face of a tremendous national debt and expenditures, it is folly to talk about tax reductions. I am dubious about the purchasing power a tax cut will generate. The value of any conjectured purchasing power is outweighed, however, by the jeopardy in which a tax cut will place all the programs supported by taxes. * * *

that was the end of the quotation.

To reduce taxes before our expenditures and debt are manageable, Mr. Baruch held to be "uneconomic and immoral." I can state to you that as of last week his views had not changed.

For some years, and in fields other than economics, we have sailed out of hearing of the voices of experience. We are now instructed that it is "normal" to expect Federal expenditures to grow by from 4 to 5 billions annually, that the budget need not be brought into annual balance but only over some indeterminate cycle of years—which incidentally would make the preparation of an annual budget a futile and meaningless enterprise—and that it is not logical to equate the standards of individual solvency and credit with those two words applied to a government.

The case for tax reduction is indeed a strong one. As you know better than I in spite of the fact that we are at peace, the general level of personal income taxes is but little lower than in World War II and the upper brackets are confiscatory. Upper corporate taxes are actually higher than in 1945. When to this is added the rise in State and local taxation for a total take of about 34.1 percent of the dollar value of the gross national product, in 1962, it is surprising that a blunting of economic initiative has not been more noticeable. Clearly, something must be done about taxes but I respectfully submit that a tax cut alone is hazardous. It should not be the only action taken.

The bill before you is estimated to reduce the tax collected by the Government from $10 to $11 billion. The budget is not yet public and is perhaps not even firm as yet, but it is reported in the press that the eventual total under consideration will exceed the current budget by 3 or 4 billion.

This year's budget of 98.8 billion was 6.3 billion above last year's, and the average annual increase since 1957 has been over 5 billion. We are told by some economists that there is no need to feel concerned about it because the dollar value of the gross national product will rise at an annual rate of 6 percent. But that is a soft guess while expenditures are hard facts.

If the expenditures and the GNP are projected into the future on these two assumptions, it would still be 1972 before the budget could be balanced.

Meanwhile the public debt would have gone through the ceiling by $75 billion. And if the GNP grows less rapidly than 6 percent per annum, we will be under water indeed.

The obvious course is to couple tax reduction with expense reduction for we are no longer dealing with a temporary deficit. The consequences of accepting continuing deficits as a policy are the dangers of uncontrollable inflation and dollar devaluation. Both disasters are presently represented as remote, but they can come up like thunder. It would deny all precedent if a continuing growth in the Federal debt failed to expose our currency to very terrible risks—and, if so, by necessitating the imposition of Federal controls, it could totally transform our free economic system.

But Federal expenditures can be brought under control. Beyond the fixed costs of Government, interest on the public debt, maintenance and pay of the Defense Establishment, et cetera, et cetera, we are engaged today in enterprises now costing billions and involving the commitment of many billions more which it would be gratifying to continue if we were comfortably solvent but whose discontinuance will not weaken our security.

I favor generous outlays for scientific research and development, but many outstanding scientists like Dr. Vannevar Bush and Dr. Philip Abelson have questioned the wisdom of the huge amounts committed now and for the years ahead in the race to be first on the moon. The size of that project for one makes it a notable drain not only on our revenues but on other areas of science, and many scientists are critical of it for that reason.

The executive departments have proposed a number of new projects for the next fiscal year. They aggregate $3 billion, and over the next 5 years $17 billion. Many of them are very small as Government projects go, and for that reason it may have seemed churlish to the committees which reported them, to deny a few million here and there when we were appropriating billions. But the small ones add up. Whatever the justification for their individual worthiness, it would be proper, I submit, to weigh them in their cumulative effect on the deficit.

The most appealing argument for increased spending, plus a tax cut, is that it will cure or at least ameliorate substantially the unemployment situation. This takes the form that a large-scale expansion—a boom—will be generated and that everyone will thus find work. If this were only true. The theory assumes that the unemployed will be hired as a result of the increased aggregate demand. But unemployment today is unlike the unemployment in the 1930's. Today a large fraction of the unemployed are concentrated regionally, in areas depressed by specific weakness in demand for the regional product, or by man-replacing devices, as for instance, in the coalfields. Another large proportion are unskilled workers, or teenagers looking for their first jobs, or married women in search of part-time work.

The attempted solution to these kinds of unemployment by increasing the aggregate demand is a nonselective approach to a problem that is essentially selective.

President Kennedy at a press conference on October 11 recognized the fact when he said:

> We could have a great boom and still have the kind of unemployment they describe.

The kind of unemployment we have will need to be solved by making job applicants employable. This will require imaginative programs for training, retraining, and placement. There are some categories of jobs (see the daily help-wanted columns) which find no takers as well as jobs unfilled for want of skilled people.

We are likewise confronted by the curious situation that in the manufacturing industry, for example, 7.4 percent of the man-hours last year were overtime hours and paid for at premium rates. The manufacturing industry could have put all its workers on regular hours and absorbed all its unemployed. Manufacturers are cost-conscious and do not pay overtime rates without reason. The reason is the shortage of skilled workers. An expanded economy, or boom, will not crack that nut, and manufacturers by and large apparently find that some of their workers are worth paying overtime above the established wage, while other workers looking for jobs are not even worth the established wage.

The causes of high unemployment are complex—witness the great difference between the unemployment rate of heads of families (about 2.6 percent) and other classifications including persons with no one else to support (5.2 to 11 percent). I certainly do not know enough to explain this or to be dogmatic about the cure for it, but it is hard to see how increasing the gross national product and risking our credit will be the panacea.

There is said to be substantially no unemployment in Germany. We sent some experts there after World War II who advised the new government to expand public spending and ignore deficits. The conservative Germans politely overlooked this advice, adopted a conservative budget policy, and have enjoyed a sustained and spectacular economic growth ever since. Compare this example with some of our Latin American friends.

If deficit financing really promoted healthy economic growth and full employment, no country would have any problems at all. Those who have tried it have sacrificed their credit, their currencies, and their political stability.

May I summarize. There is in my view no question of the need to reduce taxes, to institute simplification of the tax structure and to remove the inequalities presently favoring some taxpayers over others. To cut taxes, however, without at the same time taking positive action to restrain expenditure may briefly stimulate economic growth at the price of inevitable inflation. The threat of inflation is well understood by the American people who have seen their dollars, represented by their savings and insurance, lose half their value between the mid-1930's and the mid-1950's.

We are properly fearful of further inflation, and we will applaud steps taken by the Congress to do more than simply to urge Government to bring expenditure and revenue into balance. Nor need this be at the expense of our defense and security. In the past 10 years while our population has increased by 19 percent, our nonwar-connected expenditures have swollen by 245 percent.

In closing, gentlemen, may I leave with you a thought expressed by a great American whose name has long been associated with thrift. Benjamin Franklin said this:

> The taxes are indeed heavy and if those laid on us by the Government were the only ones we had to pay, we might more easily discharge them; but we have many others and more grievous to some of us. We are taxed twice as much by our idleness, three times as much by our pride, and four times as much by our folly * * *.

that is the end of the quotation.

Now for "idleness," read "featherbedding"—for "pride," read "spending billions for prestige"—for "folly," read "dissipating our substance in futile attempts to buy the good will of despots."

Thank you, Mr. Chairman; that is the end of our statement.

The CHAIRMAN. Admiral Strauss, I want to congratulate you on a very fine statement. I am especially impressed in what you said that tax reduction would not relieve unemployment. I agree with you, and the fact that 7.4 percent of man-hours were overtime hours. I had not seen that figure before, and paid for at premium rates. Of course, it would be impossible, I imagine, to eliminate all overtime, but you suggest the elimination of some overtime, a great deal of it, could be accomplished and increase the employment.

Also, the expanding economy is due to a great deal of unemployment being unskilled workers.

There is another thing about unemployment which is not shown by the records that are given to us, as to how many, as to whether a family, for example, that has two employed, if they lose one, one becomes unemployed, then the other can help to support the family.

Now, the records we have do not show these figures. So, I want to congratulate you on a statement which will have wide circulation, especially because you have emphasized the great danger of increasing expenditures at the same time that we reduce taxes. It is for that reason that I have been urging that the Finance Committee and the Congress be given a look at the new budget before the tax bill is passed.

So, I thank you very much for this contribution.

Senator Gore?

Senator GORE. Admiral, I have listened with interest to your able statement. I think it is fair to say that one of the principal reasons or arguments advanced for passage of the pending bill is that it will insure against a recession in 1964. We are not very far from 1964.

Would you describe in terms of the level of profits, liquidity, and savings, the national economy as of today?

Mr. STRAUSS. Senator Gore, I think that today we are liquid in all of these aspects with the possible exception of individual installment credit. I do not have the figure before me, but I believe that is very nearly at an alltime high. I think the country is healthy today. I will go one step further than your question, but I presume that it is the next point you were to raise, as to whether these steps would prevent a recession in 1964. I think they will. I think they will produce a state of euphoria in 1964 for which we will pay very large—pay a very large price in subsequent years. This will be a shot in the arm, but not a permanent one. Nor do I think that a recession threatens in 1964.

Senator GORE. I did not understand.

Mr. STRAUSS. Nor do I see anything on the horizon that threatens a recession in 1964.

Senator GORE. Well, you touched on two points I wanted to analyze with you with respect to insurance against recession in 1964: One, you stated that we are at a historic level of economic activity. I think profits are higher than ever before, dividend distribution is higher than ever before, retained earnings higher than ever before, liquidity of corporations is higher than ever before; indeed, Secretary Dillon, in his speech before the bankers this fall, stated that our time is characterized by an excess of savings.

So, you could not say that we are in a recession now, and you have gone so far as to say that in the immediate weeks or months ahead you see no signs of a recession in 1964.

Mr. STRAUSS. I see no signs of it. I would not like to pose as a prophet, but I see no signs whatever of a recession.

Senator GORE. Now, coming to the second point you make, suppose there were signs or suppose that there are imaginary signs, do we have no solution for a threatened recession or an imaginary threat of a recession, except to further increase the deficit by cutting taxes? Suppose we meet such a threat or imaginary threat in 1964, and then encounter a real threat in 1966. Do we again cut the level of governmental revenue and create bigger deficits?

Mr. STRAUSS. Well, this is just the point—how long a man can live on drugs. Every attempt to affect the economy by Government measures over the past 20 years, over the past 30 years, has, I believe, been met by failure. We were in a deep recession in the 1930's from which we were relieved not by any steps that were taken but by the war. There is serious doubt on the part of many qualified economists as to whether Government spending, as compared to other forms of activity, actually accomplish anything in the way of relieving a depression. This is a matter of opinion, but I am inclined to think that they are correct.

Senator GORE. Well, it is interesting to note in that connection that taxes were reduced in 1954 by approximately the same percent of gross national product which is now proposed.

There followed a temporary spur to the economy, an expansion in plant and facilities which, you say, would likely follow the enactment of the present bill.

Mr. STRAUSS. I think it would follow the enactment of the bill.

Senator GORE. But the general level of consumer purchasing power did not increase in sufficient amount to provide utilization of the new plant and facilities. So, by 1958—in 1957 and 1958—we were back in a recessionary condition.

So, even though the pending bill, if enacted, would provide a temporary surge to our economy, it might, in the long run, be more hurtful than helpful. In that regard, I would like to ask you if you can identify any shortage in productive capacity?

Mr. STRAUSS. I am not familiar with any shortage in productive capacity, Senator. There may be in some of the smaller industries such a condition, but in aluminum, in steel, in rubber, in coal, in oil, I know of no shortage.

Senator GORE. Well, I have asked a number of times in this hearing for citation of a shortage of productive capacity. No one has yet submitted to this committee any shortage of productive capacity. Our trouble seems to be lack of utilization of productive capacity, lack of consumer demand to bring into use the productive capacity.

But let us suppose that the pending bill would stimulate improvement in plant and facilities as other tax measures have, both in 1954 and last year, with the investment credit and depreciation changes.

The fact stands, Admiral, that this improvement in plant and facilities has not brought about more employment in manufacturing. To the contrary, there has not been a single new job yet added to manufacturing in a decade. On the contrary, with all of the increased productivity, with all of the new products on the market today, there are 600,000 fewer people in employment in manufacturing today than 10 years ago.

So, where is there justification for believing that a further tax incentive to automation will increase employment?

Mr. STRAUSS. As I have said in my statement, I don't think that it will. I think employment can be increased only by providing more skilled people. No one builds a new plant today without having it designed to include every automatic device that will make the product cheaper, since labor is the largest factor in cost, naturally so, and since cost is the criterion of whether or not the manufacturer can sell his product domestically and in competition with the foreign goods that come in, and with the foreign labor that produces them.

In consequence, there will be with plant expansion, such plant expansion as may occur, a continual pressure to build plants that will employ fewer people than the plants which the new plants will make obsolete.

Senator GORE. The second argument for enactment of this bill, it seems to me, is that it will create jobs.

Now, you have dealt with that in your statement. Lest I trespass upon time, which all members like to share, I will not go into the second point; you have touched on it already.

You and I might disagree as to what would be the best plan to solve our problem. I am not sure that either of us has the answer or that the answer is fully known. But at least we would agree that the pending bill does not provide an answer to the unemployment problem.

Mr. STRAUSS. That is my conviction, Senator.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. I have no questions.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Admiral, did I understand you to say in 1962, 34 percent of our gross national product was paid in taxes?

Mr. STRAUSS. That includes the State and local taxation with the Federal. The Federal taxation took about 24 percent, 24 and a fraction, and the difference is the inclusion of State and local.

Senator TALMADGE. Do you know of any other country on the face of the earth where 34 percent of their gross national product goes into taxes?

Mr. STRAUSS. I am not familiar with the economy of other countries to know, Senator Talmadge, but I would be sure that if there are any others or if they take any more than that we are up in the—we are at the top of the class, very close to it.

Senator TALMADGE. Thank you.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. Mr. Chairman, only this. I certainly appreciate your very excellent statement here this morning, Admiral Strauss. As one member of this committee that would like to see a tax reduction and also see a reduction in unemployment, I am concerned, we had a 500,000 reduction in employment last week, and it does concern us and I have grave doubts that this bill will bring about more employment, much as I hope it will. I appreciate your statement.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bennett?

Senator BENNETT. I have no questions but I would like to add my commendation for the clarity of the presentation.

The CHAIRMAN. Senator Morton?

Senator MORTON. No questions.

The CHAIRMAN. Senator Dirksen?

Senator DIRKSEN. Glad to see you.

Senator GORE. Mr. Chairman, I would like to make one additional point.

The pending bill, according to your views, is not needed as insurance against recession in 1964 and will not solve the problem of unemployment or make even a significant contribution toward that solution?

Mr. STRAUSS. That is my belief, and my statement could have been condensed into that sentence.

Senator GORE. There are great needs in our society, one of which is more employment, one of which is lack of adequate educational opportunity, one of which is the need for community facilities, another of which is the need for better health facilities.

The pending bill will provide no solution to these and other pressing needs of our society, as I am sure you would agree. Instead, by reducing the percentage of gross national product that goes to governmental revenue, the ability of the Government to provide solutions to these pressing needs, all of which are in the public sector of our economy, will be permanently impaired, in my view.

Would you comment thereupon?

Mr. STRAUSS. Well, I don't know whether the reduction in tax receipts of the Government will impair the Government's ability to do something about unemployment.

Unemployment is the great cancer in our economy today about which something must be done. But the spending of money by the Government, that is to say, the spending of large sums by the Government is not the answer, as I see it. If I am correct in assuming that there is work for skilled people, and not for unskilled, then the job is one of converting the unskilled body of labor into skilled labor. This isn't done by pumping a lot of money into expansion. Increasing the gross national product does not make a skilled worker out of an unskilled worker, and the moment that there is a recession, even a small one, the unskilled workers are out of jobs again.

I have looked at the help-wanted columns of newspapers, they are as long as they ever were. There are plenty, there seem to be a considerable number of jobs for which there are no takers.

Now, this is intolerable in a situation where people are out of work.

Senator GORE. It seems to me that what you are saying here is that the problem of unemployment needs specific treatment.

Mr. STRAUSS. Precisely.

Senator GORE. Rather than general.

Mr. STRAUSS. Precisely.

Senator GORE. Let us turn to one other of these serious problems of our society. Saturday night, after a banquet for a football team on which my son in high school plays, some of the fathers of other teammates and I gathered together for a session, and the problem of availability of colleage training to the boys coming out of high school this year, next year, and the immediate years ahead, was presented. And I must say that I was very deeply impressed with the problems which boys are facing now in finding an opportunity to go to a good college.

Are you aware of the sudden multiplication of the number of boys and girls coming out of high schools now and how it is to be multiplied more in the next 10 years?

Mr. STRAUSS. I am, Senator. I am on the boards of some educational institutions and this is a subject with which I am to some extent familiar. It is an area in which Federal money might well be spent. It is an investment rather than an expenditure. It is a capital investment in the future.

Senator GORE. Do you know of any sort of an investment that offers greater promise of dividends, both economically and socially, than an investment in educational facilities for the youth of today to receive training necessary for tomorrow?

Mr. STRAUSS. No, I think it is the preeminent demand. Right after national defense.

Senator GORE. So, I will not go further. I will not belabor the point. My deep conviction is that the pending bill provides no solution whatsoever for any of the most pressing needs of our society, but instead impairs at least the financial capacity of the Government to provide such solutions. I do not ask you to endorse that view, and I will not press it further.

Mr. STRAUSS. I don't feel qualified to comment, Senator.

Senator GORE. Thank you very much, Mr. Chairman.

The CHAIRMAN. Admiral, thank you very much, sir. You have made a very valuable contribution.

The next witness is Mr. James B. Carey of the AFL-CIO.

Mr. Carey, take a seat, sir, and proceed.

STATEMENT OF JAMES B. CAREY, SECRETARY-TREASURER, INDUSTRIAL UNION DEPARTMENT, AFL-CIO, AND PRESIDENT, INTERNATIONAL UNION OF ELECTRICAL, RADIO & MACHINE WORKERS OF AMERICA

Mr. CAREY. On behalf of the Industrial Union Department, AFL-CIO, of which I am secretary-treasurer, and which represents more than 6 million AFL-CIO members, and the International Union of Electrical, Radio & Machine Workers, of which I am president, and

which represents more than 425,000 members, I welcome this opportunity to testify on the proposed Revenue Act of 1963—and we continue to hope that 1963 still has meaning in this context.

We of organized labor have long been strong advocates of the bold use of fiscal policy, including tax policy, as one of the principal instruments of a national economic program. Therefore, not only are we deeply concerned that any tax bill which the Congress passes will safeguard all legitimate interests of equity, but we also regard the enactment of a major tax cut at this time as a vital step in restoring full employment to our stagnating economy.

We realize that your committee must weigh carefully many problems as it considers new tax legislation. As you do this, however, we urge that you give the most serious consideration to the necessity for a broad tax cut to help eliminate the high level of unemployment in the American economy. We of organized labor have borne a large part of the hardships and deprivations that have resulted from postwar recession and continuing mass unemployment, and we look hopefully to this proposed tax cut to help reverse these conditions.

If union witnesses before your committee at times appear to be preoccupied with the themes of unemployment and full employment and the need for vigorous fiscal action, I assure you there is good reason. Today, 2½ years after the beginning of one of the longest sustained recoveries in American economic history, we are still staggering under the burden of a national unemployment rate of at least 5½ percent. This is twice the level which we judge workable or permissible in a healthy American economy. Actually the Nation has been saddled with an unemployment rate of 5 percent for every single month of the past 6 years.

During these 6 years our Government has tried to pursue what some would call responsible fiscal and budgetary policy. There has been no deliberate, substantial effort to use taxing and spending policy to pull us out of this long period of stagnation. The results in terms of unemployment and the appalling loss of billions of dollars in wealth which a full-employment economy would have produced are apparent to all by now. But the results measured in budgetary terms have also been anything but a success. During these past 6 years the Government's budget has registered a deficit five times and was barely in balance in fiscal year 1960.

We contend that the pursuit of these policies has not been fiscal responsibility; it has been a form of national economic irresponsibility. We believe that an intelligent program of tax cuts now plus Federal spending to support vitally needed public facilities and services is the only road to attain the Nation's related goals of full employment and fiscal responsibility. With the return of full employment, the Nation's gross national product and the income of the American people will rise to a point where budget balancing can again become a practical and useful device in our economy. The results of the vain efforts of the past 6 years, which have produced both a high level of unemployment and unbalanced budgets, should put an end to the illusion that the pursuit of a balanced budget at all costs and at all times is a fiscal or economic desirability.

You will notice that I have stated that we believe a combined program of major tax cuts and intelligent well-directed Federal spending

is vitally needed to restore the Nation to full employment. I cannot refrain from adding that we oppose any policy of clamping artificial limits on necessary public expenditures. A sound policy of public improvements is a necessary complement to the proposed tax cuts. A growing America must not starve its public sector. Our expanding population needs more public services and our economy will not grow effectively if we fail to support such basic underpinnings of resource development as education, public health, road construction, and public buildings.

Of course, today we are only dealing with the tax aspect, but we should like to make it clear that your committee and, indeed, the entire Congress and the executive branch have a rare opportunity. It is obvious that major tax cuts such as are now being considered cannot often be undertaken. We urge you to use this opportunity to maximize the possibilities for sustained economic growth.

In this connection we call your attention to the fact that in its present form the tax legislation will not make its full potential contribution to restoring the economy and reducing unemployment. In order to accomplish this, the tax cut must be concentrated among low- and middle-income families to generate maximum purchasing power. In drafting this legislation, Congress must face the fact that the American economy has been suffering from an inadequacy of consumer buying power, a lack of customers to buy up its enormous potential output.

As we have studied this legislation we find that the House bill which now stands before you does not recognize this sufficiently. The House bill is disproportional in its cuts, favoring high-income individuals and families. For example, although those enjoying an income of $10,000 or more comprise only 15 percent of all taxpayers, under the proposed income tax cuts this relatively small group would receive tax savings of $3½ billion, or over 35 percent of the total income tax reduction being proposed. These same families would be the prime beneficiaries of the proposed corporate tax cut of $2⅓ billion.

The Senate must improve the House bill and provide a greater degree of tax relief for the low- and middle-income groups. One way in which this can be done is to apply the proposal of the AFL-CIO to divide the first bracket of personal income tax into two parts, with a 12-percent rate to be applied to the first of these parts, and a 15-percent rate to the second. In addition, the minimum standard deduction should be set at $400, plus $200 for each dependent. Both these steps would strengthen the buying power of low-income families, America's greatest untapped reservoir of economic demand. These changes would provide a married couple with two dependents a minimum tax-free income of $3,400; and the couple with four dependents a tax-free income of $5,000. Surely America can do no less than this.

Tax cuts concentrated in the hands of low- and middle-income groups will be immediately translated into high velocity purchasing power which can help move American industry back to full production and full employment.

We also call upon the Senate to eliminate the House proposal to end the tax exclusion of sick pay up to $100 a week, except after 30 days of illness. Seventy-five percent of the funds to be collected under this proposal would come from families with incomes under $10,000 a year, the very families whose purchasing power needs bolstering, not reducing.

Speaking on behalf of millions of ordinary wage earners, we feel very strongly about this proposed House action. We feel that there has been a great deal of confusion about this matter of taxing sick pay.

Most workers do not receive regular wages from their employer when they are absent from work because of a sickness or accident. Under negotiated agreements they receive a sickness and accident benefit which generally represents only 50 to 65 percent, or less, of their weekly wage, and usually for a limited number of weeks.

Prior to 1954, continued full-wage payments by an employer during periods of illness were taxable although sickness and accident benefits (at least if provided through group insurance) were not and had never been taxable as income to workers. In 1954 Congress wiped out this distinction. Continued wages and insured and noninsured benefits received during periods of illness were excluded, up to $100 a week, from gross income. The tax bill, as passed by the House, would impose a tax on all these payments for the first 30 days of illness. It makes no distinction between full wages and limited benefits received during periods of illness.

There is considerable difference between continuing a tax deduction during a period when a worker continues to receive his regular wages and deducting 20 percent from an income that has been curtailed during a period of illness or injury.

We agree with the basic intent of the House bill to eliminate the possibility that the tax exemption of sickness and accident benefits will be used as a tax avoidance device.

The present law which limits the tax-exempt amount of weekly income to $100—or some other limitation which would eliminate the tax exemption of continued full-wage payments for an indefinite period—avoids tax-evasion gimmicks. There is no question but that the bill's intent would be accomplished if, in the case of illness, the tax were limited to amounts which are in excess of the amount of the weekly after-tax wage which a person receives while he is at work.

Please do not misunderstand me, however; we believe strongly that where there is an opportunity to eliminate genuine loopholes in the tax structure, this opportunity must be seized. We therefore support the House proposal to eliminate the so-called dividend credit and urge the Senate to keep this provision in the bill. The dividend credit stands as one of the most glaring loopholes in the tax structure. It is a loophole through which benefits flow very largely to the highest income families. When one considers the sharp reductions being made in the rate structure affecting the higher income groups, in this proposed legislation, failure to close this loophole would be a particularly grievous omission.

Another flagrant loophole which needs closing is the present tax provision governing stock options. The House bill takes a minor step in this direction by tightening the eligibility provisions with regard to stock options. This does not touch the really glaring loophole under which enormous windfalls handed to corporation executives via the stock option route are not treated as regular income but instead are accorded capital gains treatment.

Stock options have become a get-rich-quick device—an unconscionable device which almost overnight can transform a medium-income corporation executive with such options into a millionaire, and without his being involved in more than a few paper transactions.

We think the whole system of stock options is discriminatory, and in the sense that it is condoned and encouraged by legislation it is class legislation. At the very least we urge Congress to take steps to treat the difference between the option price and the market value at the time stocks are purchased as ordinary income to be taxed at regular rates.

Just as we support proposals to eliminate or close existing loopholes in the Federal tax structure, we also oppose extending or opening wider some of those loopholes which already exist. One such wrong step is the proposed House reduction in the capital-gains tax. The administration had originally proposed some reduction in the capital gains rate as part of a substantial improvement in the capital gains tax structure. The intent of the administration was to tax those accrued capital gains which are transferred in the form of a gift or inheritance. It has long been recognized that this loophole is one of the most atrocious in the whole individual income tax structure since it exempts from taxation many billion dollars of income.

Contrary to the administration's proposals, the House did nothing about capital gains which are transferred by gifts or bequest; however, the House then went on to reduce the capital gains tax rate as such.

This is totally unjustified. In the face of the very sharp slash in tax rates for ordinary income in the highest brackets, the proposed additional reduction in capital gains taxes cannot be defended. The very people who would gain from the cuts in the highest income brackets are those who have received the lion's share of benefits from the decrease in capital gains taxes. Nearly half of all capital gains is accounted for by those with incomes above $25,000.

We urge that the Senate throw out the House proposals to change the capital gains tax. There is need for revision of this part of the Federal tax structure but it must be undertaken in a deliberate and comprehensive manner at some time in the future. The proposed piecemeal changes under the House bill would do harm and not correct what are admitted weaknesses in present capital gains taxes.

Finally, let me make some comments about the proposals in the House bill on corporation taxes. In light of the $2½ billion tax cut granted to business in 1962, as a result of Treasury action on depreciation and the corporate income tax credit, further proposals to lower the general corporate tax rate makes no sense. The financial position of American business has never been stronger. Its holdings of cash and Government securities are at an all-time high. In 1962, funds available from depreciation and retained earnings exceeded investment in new plant and equipment, and record corporate profits are still rising. There is simply no justification for a cut in the general corporate tax rate. We do, however, support the proposal in the House bill to assist small business by cutting the tax rate on the first $25,000 of corporate profits from 30 to 22 percent.

Concluding, let me say that we of the labor movement realize the difficulties which confront Congress as it tries to shape tax legislation this year. It is clear that full advantage must be taken of the opportunity to put into effect such tax reforms as the closing of the dividend credit loophole and the elimination of some of the worst abuses of the stock option racket—and we do term it a racket. But I should also like to emphasize again our great concern for a major tax cut now to

help propel the American economy forward. This Congress has the power to improve the prospects for full employment and maximum economic growth in the 1960's. Effective action now to pass tax legislation which offers economic relief for the Nation's consumers and its low- and middle-income families, would be a major stimulus toward the swift conversion of our economy from its dead center status of 5 to 6 million jobless to a burgeoning economy of full employment, increased consumption, and constantly higher living standards.

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

Senator Gore?

Senator GORE. I defer to my colleague.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Carey, you have certainly made many suggestions here which certainly deserve consideration of this committee and they will be considered. There is a possibility that none of the suggestions, whether you and I agree with them or not, may be accepted; and just assuming that none are accepted and the bill is left in the form in which it passed the House would you be for it or against it, your organization?

Mr. CAREY. We would be for it, sir.

Senator WILLIAMS. Thank you. That is all.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Carlson?

Senator CARLSON. No questions, only again as I mentioned to Admiral Strauss, I am worried about the situation confronting our Nation and I appreciate your statement. In your own statement you realize there are some problems in regard to this, in regard to securing an employment program that will really put our people to work?

Mr. CAREY. Senator, I appreciate being associated with Admiral Strauss; as I had been in several Government operations, I consider him a friend. I can understand that Admiral Strauss has no concern about income or unemployment.

I imagine Admiral Strauss could well pay the taxes that I propose in this testimony—he can even get by without the tax options. He might get by without a great number of other items but, sir, I wouldn't want to be associated with the kind of testimony that Admiral Strauss gave here. It might be high type 19th century mercantile economics, but the young people of this Nation should have an opportunity for employment in the areas in which they have been trained. It is not the unemployed in this country who are to be put in a position of resolving this problem. They are certainly not the ones who are responsible for the four recessions that we have had since the war.

And, sir, I don't care to be associated with the only solution that Admiral Strauss presented as having proved successful as a way to solve mass unemployment, and to eliminate depressions: that is to have a war.

Sir, I think the inventiveness of this Senate could provide other devices. We do have to have an expanding economy. It is not because we don't have enough skilled people that we lack this. We

have millions of skilled people who are unemployed in this Nation.

We have youngsters who are being trained for jobs that won't exist when they leave the schools and colleges. As to the question of the overtime being eliminated, we would favor that, sir.

And I know in my own industry, there are 88,000 people in my own industry whose last jobs were connected with our industry who are now unemployed, and they happen to be very skilled and well-trained people.

If we eliminated overtime, we would give full-time employment to 60,000 of those 88,000.

Let me say this: The time-and-a-half provision that we require in our contracts is not a sufficient penalty on the employers to prevent them from having people work overtime. That is because we now have a high percentage of the wage bill paid in pensions and insurance and holidays and vacations. We will have to move to make a double time penalty, if it is to be equated with what the time-and-a-half did over 40 hours in previous years.

But I would suggest that we look at this question of the unemployment, especially of the young people getting out of schools and colleges. I don't think this generation has the right to deny that generation the opportunity of using their training and their skills. I do think, sir, that it is necessary that when we quote President Kennedy as Admiral Strauss did, that we might quote President Kennedy in context, because as I knew the man, and as the President, he was in favor of this tax cut now. I wish Admiral Strauss hadn't quoted Benjamin Franklin—who was the first electrical worker of the United States when he flew his kite in the air because he happens to be an honorary member of the IUE—without his consent. [Laughter.]

I think Benjamin Franklin was a great statesman. He was the greatest of all the electrical workers and he made a great contribution. I have listened to a great deal of testimony that there is no market for sputniks, and that we shouldn't develop our knowledge in space, and we shouldn't make expenditures to find what makes green grass and things of that nature, but I would say, even over and above the training of people, we ought to have opportunity for them to use the training constructively.

I am sorry, I made a speech.

Senator CARLSON. Mr. Carey, I am pleased I gave you an opportunity to make a statement that is even better than your paper. I appreciate very much getting your views on it.

Of course, I would not want you to leave the stand without at least my expressing my personal views that you are not the only one who is concerned about this unemployment problem.

There are members around this committee—I have no doubt that Admiral Strauss is concerned about it although you made some comments that you thought it didn't make much difference to him. I don't think it is true of any patriotic American.

Senator GORE. I think he meant he was personally not involved with his own unemployment.

Senator CARLSON. I had no concern about it, at least, and I don't want the record to be left in that condition.

Mr. CAREY. Senator, I am speaking of what are the solutions. I changed from day to night school in 1929. But I am speaking here not just for myself. I am speaking here for over 6 million people who are part of the industrial life of America and I know why heads of families have a higher percentage of employment and a lower percentage of unemployment in proportion to people getting out of schools and colleges, and in proportion, whites above Negroes and things of that nature.

But, sir, I would contend that these people for whom I did speak are concerned, even those who are employed, they are concerned, about this growing unemployment. We don't want to just muddle through. We think our Government does have a responsibility, and just a fulfillment of the principles of the full employment act of 1947 would do much toward it.

But I do want to give some hope to the people of America that war is not the only way of dealing with unemployment.

Thank you very much, and thank you for pointing up that point which would otherwise be misunderstood.

The CHAIRMAN. Senator Bennett?

Senator Dirksen?

Senator DIRKSEN. Well, Mr. Carey, this is only indirectly related. What is the impact of the importation of electronic equipment from foreign countries upon employment in your view?

Mr. CAREY. Sir, we are a big exporter of electrical goods and we export in electrical goods far, far more than import. I am not here pleading for higher tariffs or things of that nature. But I have traveled through Western Germany, and I have traveled and seen plants in Japan and other places in the world, and there is no group of workers who can come anywhere near the people of the United States when they are employed.

We can outproduce them competitively. And when they speak of the fear of foreign competition, sir, I am reminded of the fact that most of the money that is invested in those countries, like Western Germany that was mentioned earlier, and Japan, is American-produced investments. They are American-managed plants and they are American-owned plants and they use American-made machinery in those plants and yet we can outcompete them in the electronics field.

I am not sure we can in certain other areas, but I represent the industry that produces the electronics devices, in fact, produces the automation equipment. Senator Dirksen, we are producing automation equipment on automatic equipment, and this is not a matter that can be lightly dealt with.

And we are, as our country is investing in Japan, and West Germany, and elsewhere in the world, introducing automatic equipment, where there is no great need for it in the sense that they have available labor. They are displacing workers and creating problems in those economies.

Now, one of our companies produces an artificial diamond, industrial diamonds which could upset a couple of economies in Africa. When Du Pont produced artificial goods, it put all the silkworms out of work in Japan. But we are talking here about people, and I have little fear of competition from abroad if we have fair competition, and we have to have some fair standards in international competition.

Senator DIRKSEN. Well, my question was a very simple one.

What effect does the volume of transistors and electronics equipment of all kinds brought from Europe, Japan, and elsewhere have by way of impact on employment in your industry?

Mr. CAREY. Well, in our industry it is not a serious matter except for some items that are largely produced by, and for, the companies in the United States that we work for. We don't favor an arrangement where they appear to be made here.

In fair competition we could do awfully well in all the products that we make, because we have such an extremely large market in this country, and we have the trained people, and management with initiative. Really, sir, we are competing with ourselves on these items. U.S. companies that are placing plants abroad are the same companies that we deal with here, whether it is Canada or Germany or whether it is Japan, and we have problems growing out of that. I think some of those problems can be met by tax reform as well. You know capital that we produce here is used for the purpose of making unfair competition by the utilization of lower wage conditions in other parts of the world; and they charge against the American-made products all the costs of engineering, all the costs of distribution, all the costs of advertising, and things of that nature, and the products come in from Japan and other countries under the names of the companies here, and they disguise the fact that the products are produced abroad under conditions that we would consider unfair competitive practices.

Senator DIRKSEN. Thank you very much.

Senator Gore?

Senator GORE. Mr. Carey, you have advocated in your statement, and strongly urged this committee to adopt, amendments which would amount to substantial, and I think equitable, tax reforms. I concur in your general recommendations in this regard and have offered amendments to accomplish some of them.

When Mr. Biemiller was testifying on behalf of the AFL–CIO before the committee, he suggested and recommended amendments similar to your recommendations, and some in addition.

I solicited his aid in having the amendments drafted in legal form, and he promised that the legal department of the AFL–CIO would supply such drafts. I have not received them. I wonder if you could be of some assistance in getting those amendments submitted to the committee.

Mr. CAREY. Senator, in addition to being secretary-treasurer of the industrial union department and president of the International Union of Electrical, Radio & Machine Workers, I am also a vice president of the AFL–CIO and a member of its executive committee.

I will move within the hour to get those statements prepared.

Senator GORE. Thank you very much.

It seems to me, Mr. Carey, that one of the prime needs of our society is tax reform. I am sure you have seen or heard statements by Senator Douglas to the effect that there are a number of men who have received annual incomes in excess of $1 million who have paid no taxes whatsoever.

Have you seen the table which the Treasury supplied to this committee which gives the amount of taxes which a typical taxpayer pays in various income groups?

Mr. CAREY. I am not entirely familiar with it. But I have had experience in dealing with executives in my own industry who overnight become millionaires, and a large part of it is due to the loopholes in the tax structure. We note the problem of stock options that they vote for themselves. I have addressed myself to this at a stockholders meeting of the General Electric Co.

I think it is a sad situation that working people feel that this is something that must be dealt with, even if we have to have some of the proper tax reforms wait over until some later date. But the suggestions I have made in my statement in my humble opinion, are of the things that are necessary now. When I replied to Senator Williams' question, if they don't adopt those suggestions we would still be in favor of the bill, the answer is yes, sir; not as enthusiastically as we would be if they were adopted.

And thank you, Senator, for the contribution that you are making in trying to bring about understanding about this whole question of taxation.

Senator GORE. Well, I appreciate that, Mr. Carey. My efforts are appreciated by some and deprecated by others. I daresay I would be a considerably more popular man if I did not serve on this committee. But this is my duty as I see it, and I think one must perform his duty as he sees it.

But let me get back to this table. I think this committee was astounded to learn that the typical taxpayer—I am not talking about the odd-ball or the man who has an unusual or exceptional situation, I am speaking now of the typical taxpayer—with an income of $1 million a year, adjusted gross income of $1 million a year, pays only 26 percent of that in taxes.

Mr. CAREY. I didn't realize until I read some of the documents that Senator Douglas had secured and——

Senator GORE. Senator Douglas didn't supply this one. The Treasury supplied this one, at my request, and do you realize that after this pending bill is enacted, if it is, that typical taxpayer will then pay only 23 percent. Some of your electrical workers pay in that bracket, do they not?

Mr. CAREY. Yes, sir.

Senator GORE. Do you think it is fair for an electrical worker who labors by the day or by the night on hourly wages, and has a modest income, to pay in the same percentage income bracket as the typical taxpayer with an adjusted gross income of $1 million per year?

Mr. CAREY. No, sir; I don't think it is fair, and I think it ought to be corrected.

Sir, I thought this capital gains cut would take it down to as low as 21 percent.

Senator GORE. Well, the provision in the bill with respect to capital gains tax is one of the ways, but only one of the ways, in which this bill would lower the tax liability of the typical taxpayer with an income of $1 million a year, from 26 to 23 percent. This provision on capital gains goes in exactly the opposite direction from the way equity and right would indicate, and far too much income is considered as capital gains when it should be considered as ordinary income.

The provision in the bill makes it worse.

Now, this, it seems to me, adds up to political immorality for this bill. In my view, instead of improving a highly inequitable and unfair system of taxation, it makes it worse, and I must say to you in all candor, that I have been dumfounded that organized labor would be deluded into the support of this bill that it has.

Mr. CAREY. Well, sir, when you contrast it with the fact that this bill is going to tax a sick worker, a wage earner, the head of a family, on his sick pay at the same time giving the additional relief, you point up the immorality of it.

As to why we would be a party to this proposition I must say, sir, because of the urgency of the Nation is in need, call it blackmail or call it what you may, but there has been so much long delay in dealing with this problem of unemployment, and it becomes an explosive situation in our Nation.

In this contest in the world between the Communists and the free peoples, we want to remain free. We are willing to sacrifice in order to accomplish that. But they have in ex-enemy countries, as Admiral Strauss pointed up, full employment in West Germany, for example.

We have full employment in some of the Communist countries, sir, and we regret that all these years have gone by when we have adopted this myth that you have to have a balanced budget even if it is balanced over the backs of the people of the Nation.

But we do support an immediate tax cut, even if it doesn't contain all the reforms that are rotten ripe for adoption.

I would say, sir, that it is high time that we had people dealing with the fiscal policies of our Nation who dealt with this problem and provided us with an equitable arrangement, and I speak for people who pay their taxes, and they don't gripe about it and they don't chase around looking for loopholes, and in addition they pay union dues and they make other contributions to an economy.

Certainly, this bill, as it stands now is not everything that we think the people of this Nation deserve. But the least we think ought to be adopted are some of the amendments to the House version of this piece of legislation at this time and we think it should be done now.

Senator GORE. Well, Mr. Carey, as I gather from your statement, and from the statement of Mr. Biemiller, almost the sole basis on which you support this bill, however reluctantly, if the amendments you suggest are not adopted, and you may be sure they will not be, is that it will provide more jobs and the leaders of organized labor, as well as the leaders of our Government, the Secretary of the Treasury, the President, wrap around themselves the cloak of more jobs as an excuse for supporting this bill when there is no substantial evidence that the pending bill will make any significant dent in the unemployment problem. But by reducing permanently, on the other hand, the percentage of the gross national product that will be available to the Government for programs of action it will permanently impair the ability of the Government to make significant progress in the solution not only of the problem of unemployment, but the many other needs of our society. I say this to you in all candor, and in appreciation for the loyalty and friendship which I have enjoyed from organized labor, I am simply dumbfounded that able leaders like yourself could be deluded into the support of this bill, as inequitable as it is, and as ineffec-

tual as it is apt to be in the solution of the problems with which you are most concerned.

Mr. CAREY. I think that is a pretty reasonable statement, Senator.

Senator GORE. Thank you.

Mr. CAREY. We are not deluded. We might be disillusioned by our experience in dealing with Government in the past but we don't want the people of the United States to lose their confidence in the tax structure or in the Government. I can understand how 6 million people could readily lose their confidence. I could understand how we can appear to be deliberately losing the confidence of the young people of this Nation.

How we can take the deliberate action to destroy any hope of gaining the confidence of minority groups as unemployment is greater with Negroes than that of whites. You might say taken in by this proposition but we are clamoring for equality of opportunity in employment but we must say each man will have more than the right to be unemployed.

Sir, we are not deluded. We are, of course, still trying. I don't agree with you, Senator, on only one part. That these proposals will not be adopted. I think they will be, whether in this Congress or some other Congress, but these proposals will be adopted, and we will have an equitable tax program.

But I am asking that the cut be made now, not wait until we have further crimes committed against the people of this Nation and democracy itself.

We are not considered a very respectable group in American society. I speak for labor leaders.

Senator GORE. I disagree with that.

Mr. CAREY. That is your opinion, Senator, and I welcome it. But by and large, a labor leader who represents 6 million American people will not get the kind of attention from members of this committee generally or from this Congress that a stockholder will representing one or two corporations on the question of tax legislation.

Senator GORE. Mr. Carey, I can't speak for all the American people, but I can express my own view.

Mr. CAREY. I wish you did speak for more.

Senator GORE. Thank you.

There are some people who disagree with you on that.

Mr. CAREY. I know.

Senator GORE. I must say that I regard you, and it is my sincere belief that millions of people regard you, as one of the intelligent, sincere, able, and influential men in America, and I think that this committee respects you because you have been here before, and you have always spoken candidly and courageously. So, I hope you will not deprecate your own influence.

Now, as to the adoption of these reforms now or later, let me suggest to you that unless the reforms are contained in the same bill that embodies the benefits, the rate reductions, the chance of even serious consideration is quite remote. This is one of the additional fallacies of this bill, passing the benefits, in many instances in my view unjustified benefits, without coupling this with the repeal of the special privilege provisions of the tax law which tend to bring our whole system of income taxation into disrepute among our people.

I will not ask further questions. I thank you for your testimony. You have been very helpful.

Mr. CAREY. Thank you, Senator.

May I say, Mr. Chairman, I deeply appreciated this opportunity, and I have had 30 years as a nationally elected officer, and this is not my first time in testifying before a committee, even on this subject.

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

Mr. CAREY. I am saying, Mr. Chairman, I speak with some intensity and perhaps emotion on this question of tax policy because it has so much meaning to the people of our country, and I do urge that this committee adopt the suggestions that I have proposed, and that we do provide the people of this country with this extremely important opportunity of getting out of this area of mass unemployment in our free society, if our society is to be free.

The CHAIRMAN. Thank you, Mr. Carey, for your contribution, sir. Glad to have had you.

The next witness is Mr. A. Wilfred May of New York City.

Mr. May, will you take a seat, please, and proceed.

STATEMENT OF A. WILFRED MAY, NEW YORK CITY

Mr. MAY. I am A. Wilfred May. My address is care of the Commercial & Financial Chronicle, New York City, of which publication I am executive editor. I am not representing the Chronicle, which may or may not agree with the following statement.

H.R. 8363, the Revenue Act of 1963, as passed by the House, contains some badly needed changes in the regulations concerning stock options.

Most important of these is the provision that the optionee may not sell or otherwise dispose of the stock within 3 years. This would replace the present law's requirement that the individual must hold the option and/or stock for at least 2 years, but must hold the stock alone for a mere 6 months. This change would tend to give the optionee a real stake in the business rather than merely providing him with a "heads-I-win-tails-no-dice" stock market flyer.

Likewise reducing the market-flyer character of the option process, and increasing the optionee's function of having a stake in the business, is the new provision reducing from a maximum of 10 to 5 years, the period in which the option may remain exercisable.

Also salutary is the limitation proposed on resetting; that is, of affording the privilege, in the event of a decline in the price of the stock during the option-holding period, to chase the market down with reduction of the option price—this "heads-I-win-tails-you-lose" market ride provided assured compensation.

However, the House bill continues the provision under present law, generally in the case of stock options, that any gain realized upon the sale of the stock by the employee, generally will be capital gain. Moreover, no income tax is due either at the time the option is exercised and the stock is transfererd to the employee; and no business expense deduction is allowed the employer corporation at any time.

These provisions are wholly unrealistic and unethical, and contribute a serious abuse on the stockholder.

It should be realized that price changes of stocks are not primarily the result of changes in individual company fortunes; but rather of market factors affecting the capitalization of earnings rather than the earnings themselves.

The price-earnings ratio, denoting the market's capitalization of the earnings per share, which is the result of the investor's psychological processes and sometimes called an index of confidence is controlling over both the long and short terms.

The changing price-earnings ratio of Moody's 125 Industrial Stocks since 1950 follow:

	Price-earnings ratio		Price-earnings ratio
1950	6.8	1957	14.0
1951	9.6	1958	18.0
1952	10.5	1959	18.9
1953	9.9	1960	18.0
1954	11.4	1961	20.8
1955	12.4	1962	17.1
1956	14.4	Nov. 29, 1963	18.8

We see that in the 8-year interval since 1955 (this 8-year period comprising 5 years, the maximum interval of its exercisability after granting; plus 3 years, the minimum time the stock must be held) the price-earning ratio rose by 48 percent; and since 1950, by 235 percent.

Similarly with the 30 stocks in the Dow Jones Industrial Average, the price-earnings ratio has shown wide fluctuations between 8.4 in 1950 and the current 18.7 (Nov. 29, 1963).

During the past decade, six of the Dow Jones issues enjoyed substantial net market appreciation in the face of an earnings decline, as shown in the following table:

Stock	Earnings per share		Price		Price-to-earnings ratio	
	1950	1960	1950	1960	1950	1960
American Can	$3.17	$2.06	$23	$35	7	17
Bethlehem Steel	3.04	2.52	12	39	4	16
International Paper	1.80	1.74	13	31	7	18
Johns Manville	3.61	3.12	24	57	7	18
United Aircraft	2.07	1.96	16	37	8	19
Westinghouse	2.68	2.22	17	49	6	21

Thus we see the complete fallacy of the prooption premise that the company's stock market fluctuations register the executives' efforts and achievements.

Besides psychological influences, they reflect external political and economic factors, as the course of cold war, interest rates, taxation, and so forth.

The option constitutes a valuable instrument at the time of its granting, although its exact valuation is probably not feasible here. (In Great Britain, value at the time of grant is determined by the internal revenue.) The fact of value at grant time is evidenced by Wall Street's active put-and-call option market where the price of all call options at writing time averages about 12 percent of the value of the stock called for. The put-and-call market's valuation of a call written to enjoy the longer life of the corporate option would naturally

command a higher premium—the market's premium on a 1-year option exceeds the price of 6-month paper by 50 percent.

Hence, as Secretary Dillon said in his statement to the House Ways and Means Committee, February 6, 1963, "Stock options represent compensation for services, just like wages and salaries. The special treatment of stock options should be repealed and the spread between the value of the stock at the date of option is exercised and the option price should be taxed as ordinary income at the time of exercise."

The special tax treatment accorded high-income executives is commonly justified as a needed alleviater of our high and excessive tax rates.

It must be answered in the first place, that the proposed lower income rate schedule would make it far less necessary to provide such compensation indirectly. Equivalent incentives applied with realism will be possible either through direct salary increases at the proposed lower rates; or by direct profit sharing through stock bonuses directly geared to earnings instead of to the stock markets performance.

In any event, the thesis that high tax rates are to be circumvented follows the recently growing rationalization of increasing tax loopholes in areas ranging from real estate to oil drilling to savings and loan, instead of rooting out the trouble at the source. The frank excuse of condoning such loopholes to ameliorate high tax rates is unethical, and unfair to the stockholder.

The CHAIRMAN. Thank you, Mr. May.

Any question?

The next witness is Mr. Thomas J. Wall of the Mersick Industries.

Mr. Wall, will you take a seat, please, and proceed.

STATEMENT OF THOMAS J. WALL, PRESIDENT, MERSICK INDUSTRIES, INC.

Mr. WALL. Gentlemen, I would like to speak to you only on the proposed corporate tax relief in the House bill, not on the merits of tax relief without expenditure cuts, and so on.

I officially represent the National Association of Electrical Distributors. I was surprised and pleased to have a brother electrician and user of our supplies on the panel this morning. I might just briefly say if Benjamin Franklin is entitled to be a union member he certainly is entitled to be a member of our electrical distribution association.

On the corporate tax relief, you have a prepared statement, and which was condensed and I will try to be very brief.

As I understand the House bill, there are two proposals: one is a reversal of the normal and surtax rates. This affects smaller companies earning $25,000 a year or less, and we heartily endorse it as being vital.

The second half of the proposed corporate tax relief is to grant 4-percent relief for all corporations earning above $25,000. That means if you earn $50,000 or $5 million or $50 million, you are all taxed at the same rate. This, gentlemen, we do not believe is fair.

No consideration is given for middle-income corporations. No chance is given to the smaller companies to acquire equity with which to grow.

I would like to suggest on behalf of our group a very simple solution. If you gentlemen would increase the surtax exemption level to $50,000 you would: No. 1, help more than three-quarters of the companies earning over $25,000 more than the 4-percent surtax reduction does.

No. 2, you would help any company earning $200,000 or less, more than this 4-percent surtax reduction does, and No. 3, would enable the many small companies, those earning under $25,000 who occasionally have a good year, to be able to hold on to equity capital and thus give more employment.

The House bill proposes this reversal that I just discussed. That is a wonderful percentage of tax relief, but have you stopped to realize that it gives only a maximum of $2,000; 8 percent on $25,000?

Now, you can't very well hire a new person or build an addition to your plant or take on a new line of distribution with $2,000.

Let's take the example of a company earning $50,000. Under the proposed House bill, on the first $25,000 there would be a saving of $2,000. On the next $25,000 there would be a saving of $1,000 or a total of $3,000. But if you raise the exemption level to $50,000, you would save $2,00 on the first $25,000 and $7,500 on the second $25,000 or a total of $9,500.

Now, we claim you can do something with $9,500 or if you want to look at the difference between the exemption level increase and what the House proposes it's $6,500 difference, you can do something with that per year, particularly if you project it over several years. You can certainly hire more people, you can build a plant addition if that is what seems to be required, you can take on more lines, you can create more employment.

Furthermore, I feel that, and I am sure you are all aware of this, that the larger corporations very often generate the cash they need for expansion from the depreciation credits and allowances and so on given in the last year or two. This was touched on by Mr. Carey, and by Senator Gore and by others.

There is an article in a recent issue of Newsweek which shows that point.

It shows the surge in corporate cash flow. This is the depreciation, these are earnings, and how it exceeds the capital spending. I have extra copies of this if any of you would like it.

Large corporations, the point I am trying to make, do not need the relief as much as the small and in between companies.

This statement, I think, I can verify. If you would raise the surtax exemption level to $50,000, coupled with the reversal of normal and surtax rates you would help 97 percent of the corporations in this country more than the percent proposed House bill.

Senator GORE. How about the revenue loss?

Mr. WALL. The revenue loss the Treasury Department estimates would be $470 million—$470 million revenue loss by increasing the exemption level to $50,000.

Senator GORE. Over and above the provisions of the pending bill?

Mr. WALL. That is right, sir.

Senator GORE. Thank you.

Mr. WALL. However, I, if you consider that as a logical addendum to the present bill you might consider other ways to get back to the total level.

If there is any truth to the argument of increased employment or expansion by a tax cut, certainly this is truer in the area of small business, not now helped by the depreciation regulation changes.

Admiral Strauss in his testimony said that any new plants would no doubt be fully automated, whereas tax relief granted to smaller companies would be used, I am sure you can agree with this in a way of adding employees by further distribution, by further usage of their present businesses.

Senator Gore, to your point, it is hardly up to me to suggest this, but if you wanted to maintain the same corporate reduction level that is granted in the House bill of some $2.2 or $2.3 billion, a very simple way of doing it, if you wanted, on top of the reversal of normal and surtax rates, if you wanted to give consideration seriously to increasing the exemption level of $50,000 then the equalization could be accomplished by cutting the total rate of the surtax cut instead of 4 percent over 2 years make it 3 percent and you would come out practically on the nose with the total amount of $2.2 billion.

I think that you ought to be, in considering this bill, you ought to be fair and equitable on the corporate level as well as on the personal level, and help the backbone of America, which is small industry.

That is all.

The CHAIRMAN. Thank you very much.

Any questions?

Senator GORE. In the first part of your statement you seem to be almost suggesting more graduation in the taxation of corporations. I thought you might be leading up to the suggestion that there be a middle bracket instead of stopping with the $25,000, that maybe there be a $50,000 or a $75,000 or a $100,000 level at which the taxation would be lower than, say, in the million and beyond.

But you have suggested the surtax route. What would be your view toward another step of graduation?

Mr. WALL. I would think if the graduation step is fair in personal income tax rates it certainly would be fair in corporate rates, but this suggestion I make is just a very simple insertion.

If your committee felt inclined to do so, you could very simply insert it in between the reversal of the normal and surtax rates which helps those under $25,000, and between the 4-percent corporate reduction that all other companies regardless of whether they are General Motors, General Electric, General Dynamics, or General X, Y, Z, the little company would have to pay. It would also aid any company up to $200,000 more than this 4-percent proposed corporate tax reduction on surtax.

Senator GORE. Your concern is, I gather, that more incentive, more relief, be given to the small and up to, for want of a better word, middle-sized corporation. You are not particularly set on the manner in which this additional rate is provided.

If the committee decided on a graduated system it would be acceptable to you?

Mr. WALL. Yes, sir. I just have one other point to make, and that is that these depreciation reductions that have been granted to large, which affect mainly large corporations, you take the retail businesses, the distributive businesses, the assembly-type business, light manufacturing type business, clothing and so on, they have very little invested in fixed capital, therefore, these depreciation rates mean very

little to them but most of your large corporations have been able to generate their expansion capital out of these new depreciation rates plus their earnings which is called cash flow.

Senator GORE. Thank you, Mr. Chairman.

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

(The prepared statement of Mr. Wall follows:)

STATEMENT OF MR. THOMAS J. WALL, PRESIDENT, MERSICK INDUSTRIES, INC.

My name is Thomas J. Wall. I am president of Mersick Industries, Inc., a Connecticut corporation which: (1) manufactures tanks and pressure vessels primarily for the chemical industry (in all its diversifications) at South Norwalk, Conn., and at Sistersville, W. Va.; (2) manufactures hydraulic attachments for tractors at Windsor, Vt.; and (3) distributes industrial and electrical supplies and steel to contractors and industry throughout Connecticut. Through this last activity, the wholesale distribution of supplies, we belong to various trade associations, and I speak officially for the National Association of Electrical Distributors (1,100 members) and unofficially for the Steel Service Center Institute, the National Industrial Distributors Association, American Supply Association, etc., practically all of whose members would be classified as small (in earnings) business.

I do not attempt to express an opinion here on the merits of tax relief without curbing expenditures, nor on the suggested distribution of relief in the various personal income categories. I speak to you only on the proposed corporate tax relief. As I understand it, House bill 8363 would grant relief to corporations primarily by two methods:

A "reversal" of the normal and surtax rates. At the present, corporations pay a normal tax of 30 percent on the first $25,000 of income and a surtax of an additional 22 percent (for a total of 52 percent) on anything earned over $25,000. House bill 8363 would make the normal tax 22 percent on the first $25,000 of income, and make the combination of the new normal and surtax on all income above $25,000, a total of 50 percent in 1964 and a total of 48 percent in 1965 and thereafter.

The associations I represent, heartily endorse the proposed "reversal" of the present normal and surtax rates. We are also firmly in favor of additional corporate tax reductions as being imperative to assure high employment and a strong economy.

However, we wish to point out that the present rate structure, and the new proposal, provide for the same tax rate for all corporations, so that, above the first $25,000 of earnings, 52 percent, or 50 percent, or 48 percent will be applied whether a company earns $50,000, or $500,000, or $5 million.

If you would approve the "reversal" plan, and increase the surtax exemption level to $50,000, you would bring greater tax relief to more than three-quarters of the corporations with earnings above $25,000, than that provided in H.R. 8363. by its reduction of total tax rates to 48 percent by 1964. This fact, that such a large percentage of corporations would be better off with an exemption level increase, is not generally understood, but comes to light from information very recently released by the Treasury Department:

Corporate returns with net income, 1960 (excluding 1120S returns)

Size of net income	Number of returns	Percent of total
Under $25,000	554,364	82.7
$25,000 to $50,000	58,722	8.7
$50,000 to $100,000	26,464	3.9
Over $100,000	30,689	4.6
Total	670,239	100.0

NOTE.—Above table is part of a letter sent to Senator John Pastore, Oct. 24, 1963, by Stanley S. Surrey, Assistant Secretary, Treasury Department.

From the above information, it is readily apparent that more than half of the corporations earning above $25,000, fall in the earnings category of $25,000 to $50,000. However, reference to the enclosed chart (exhibit A),

should be made to realize how many more companies than these, would be better aided by an exemption level increase. Very simply, any corporation with pretax earnings of $200,000, would gain more relief by an exemption level increase to $50,000 (coupled, of course, with the proposed "reversal"), than by the overall rate reduction to 48 percent by 1965.

I do not in any way suggest that overall rate reductions should not be passed, they are most essential for the remaining few, but large corporations on which our economy depends to a great extent. The Treasury Department estimates that "if surtax exemptions were increased to $50,000, it would cost an additional $470 million under the proposed rates." Also, that "the total cost of the corporate rate reduction provided by House bill 8363, when fully effective in 1965, is estimated at $2.2 billion."

Consideration should be given, moreover, to the following points:

1. The proposed "reversal" of present normal and surtax rates, while most helpful and essential, provides a maximum tax benefit of $2,000 (8 percent of $25,000). You cannot hire a new employee, or build an addition to your plant, or improve the economy very much with $2,000.

2. The accompanying chart (exhibit A), shows that if the surtax exemption level was raised to $50,000, a company earning $50,000 (or more), would save $6,500 additional per year over the proposal in House bill 8363. This $6,500 added to the $2,000 saving caused by the "reversal" plan, makes a total of $8,500, and you can certainly hire new people, or build a plant addition, and thus help improve the economy, with a saving of $8,500, especially if this annual saving is projected over several future years.

3. The very large corporations can often generate the cash necessary for expansions from the new depreciation credits and allowances. This can be readily ascertained from a study of the 1962 annual reports, and was currently highlighted for 1963 in Business Week's issue of October 19, 1963, showing the tremendous gain by large companies in cash flow (depreciation and profits).

4. Most small corporations, and particularly those engaged in distribution, retailing, or light manufacturing and assembly, do not have a large investment in fixed assets, and, therefore, their only cash flow comes from earnings approximately half of which (above $25,000), are taken away from them by Federal taxes.

5. "Big" business buys from and sells to, or through "small" business, and, therefore, anything that helps the smaller companies naturally helps the larger ones as well.

6. While the newly released information from the Treasury Department (outlined above, p. 2) shows that the great bulk of all corporations reporting in 1960 earned less than $25,000, a great number of these companies have hopes of one day, or occasionally, earning more than that amount. Whether these good years are brought about by diligence, or conditions, or special situations, the owners look forward to them for possible accumulation of equity with which to expand their operations. I appeal to you to give "small" business, the backbone of America, this chance by raising the surtax exemption level. After all, today's "big" business was itself once "small."

EXHIBIT A

Earnings	Tax under H.R. 8363 (rates) 22 percent and 48 percent	Tax with surtax exemption level at $50,000 (rates) 22 percent and 52 percent	Difference
$25,000	$5,500	$5,500	
$50,000	17,500	11,000	$6,500
$75,000	29,500	24,000	5,500
$100,000	41,500	37,000	4,500
$125,000	53,500	50,000	3,500
$150,000	65,500	63,000	2,500
$175,000	77,500	76,000	1,500
$200,000	89,500	89,000	500
$212,500	90,500	90,500	

NOTE.—Above chart illustrates that a company with pretax earnings of $200,000 or less, would have more tax relief from a rise in the surtax exemption level to $50,000, than from the surtax reductions proposed in H.R. 8363.

As an addendum, I would like to submit the following chart, exhibit B. I have hesitated to suggest to you any method of granting the exemption level increase to $50,000 * * * and yet not exceed the total corporate relief, approximately $2.2 billion, estimated under H.R. 8363.

The most obvious way to accomplish this, if it was your desire to do so, would be to limit the reduction in the proposed new surtax rate to 3 percent, instead of the recommended 4 percent. This would mean that by 1965 the total overall tax rate would be 49 percent * * * and while it would be granting 1 percent less reduction which would affect the very large corporation, it would be of greater help to any company earning under $700,000.

The House bill provides tax relief for the "middle income" personal taxpayer; why shouldn't consideration be given to the "middle income" corporation? The very small earnings group are aided substantially by the "reversal" plan; why should all other corporations, earning more than $25,000, be put in the same tax category?

The suggested increase in the surtax exemption level to $50,000 would seem to be a very simple way to "equalize" the proposed corporate tax reductions.

EXHIBIT B

Chart showing suggestion to raise the exemption level, and yet keep the total corporate tax reduction approximately the same as in H.R. 8363

Earnings	Tax under H.R. 8363 (rates 22 percent and 48 percent)	Tax with surtax exemption of $50,000, surtax reduction of 3 percent (rates 22 percent and 49 percent)	Difference
$25,000	$5,500	$5,500	----------
$50,000	17,500	11,000	$6,500
$100,000	41,500	35,500	6,000
$200,000	89,500	84,500	5,000
$300,000	137,500	133,500	4,000
$400,000	185,500	182,500	3,000
$500,000	233,500	231,500	2,000
$600,000	281,500	280,500	1,000
$650,000	305,500	305,000	500
$700,000	329,500	329,500	----------

NATIONAL ASSOCIATION OF ELECTRICAL DISTRIBUTORS,
St. Louis, Mo., October 31, 1963.

Mr. THOMAS J. WALL,
C. S. Mersick Electric Supply Corp.,
North Haven, Conn.

DEAR MR. WALL: First, may I express my appreciation to you for your presentation at the recent NAED eastern region meeting in New York City. I am sure you noted, as I did, the interest and the enthusiastic reaction of our members to your comments regarding the need for a rise in the surtax exemption level, in addition to the proposed reversal of normal and surtax rates.

I was happy to learn that you are willing to accept an appointment as a special representative for the National Association of Electrical Distributors to appear before the Senate Finance Committee, representing our industry, and show that committee why this move would be of benefit to smaller corporations and to our national economy.

I know that the 1,050 wholesale firms that comprise NAED will appreciate your efforts in their behalf.

I have advised our executive director, Arthur W. Hooper, and the association's staff to assist you in every way with this project.

Very sincerely yours,

C. E. BUTLER, Jr., *President.*

The CHAIRMAN. The next witness is Mr. James H. Dingeman, Federal-Mogul-Bower Bearings.

Take a seat, sir, and proceed.

Mr. DINGEMAN. Thank you, Mr. Chairman. With your permission, I will read from the prepared statement and add a few extra comments in relation thereto.

STATEMENT OF JAMES H. DINGEMAN, FEDERAL-MOGUL-BOWER BEARINGS, INC.

Mr. DINGEMAN. My name is James H. Dingeman, director of organization planning and executive development of the Federal-Mogul-Bower Bearings, Inc., with offices at 11031 Shoemaker, Detroit, Mich. The company is engaged in the manufacture and distribution of various types of sleeve-type bearings, ball bearings, roller bearings, seals, and other products for the automotive, agricultural implement, aircraft, missile, and other industries, both domestic and overseas. Certain divisions of the company had their origin as far back as 1899.

I might add my own responsibilities are twofold. I am responsible for the corporate structure of the corporation; in other words, the way in which we are organized in order to achieve our corporate objectives; and secondly, I am responsible for the selection and development of the top management and midmanagement personnel.

My purpose in being here today is to discuss one phase of Federal tax legislation; that is, the portion of it dealing with restricted stock options. I think that this committee will be interested in learning of our specific experiences and why we are vigorously in favor of the present law.

The history of stock options, and the attention they have received for 20 years, would indicate rather conclusively that Congress consistently has been impressed with their value to American enterprise and to the Nation's economy. The purpose of options has been frequently and repeatedly stated, in effect, "to allow a corporation to offer its management incentives to improve the profitability of the corporation and thereby increase the value of the company stock to the shareholder." Obviously, security and improved working conditions for its employees and increased tax payments result from the profitability of business. Government policy has long recognized this.

Much has been heard of abuses. I do not believe that we have abused either the letter or the intent of the law. Rather I believe that we have adopted meaningful option programs, in some respects more restrictive than the law requires.

Our first plan was adopted in 1952 by the shareholders of the predecessor Federal-Mogul Corp. That corporation at that time employed about 2,000 people and had a sales volume of approximately $35 million. We adopted a 95-percent-of-market-value option plan. The shareholders overwhelmingly approved authorization of 30,000 shares for future option grants as "an incentive and to encourage stock-ownership by full-time key employees." The shares amounted to 5 percent of our total capitalization. So 40 positions were designated as "key positions," wherein the proper fulfillment of the responsibilities could have a significant effect on the company's results. Options were granted to 28 employees in these positions, only 5 of whom were officers. The other 23 recipients were members of management whose efforts could contribute substantially to the company's success. More significantly, certain company officers were not granted options due to the fact that

they were already substantial shareholders and, therefore, the incentive and proprietary interest objectives were lacking support. Other executives holding these key positions were not granted options due to certain administrative tests which we impose. For example, the executive must be at least 5 years from retirement. This test validates the objective of future incentive.

This original option plan served the company well. It enabled the company to span the transition period from that of proprietary management to so-called professional management with a proprietary interest. Certainly it was a major factor in providing incentive for the growth of the company during the next few years, through both the expansion of our existing products and markets as well as through beneficial acquisitions or mergers.

During the period of 1953–57 there were several significant mergers. Subsequently, the board of directors of the merged company submitted a new option plan to its shareholders. The purposes of this plan were, again, to provide "an incentive and to encourage stock ownership." As in the prior plan, a relatively small portion (2 percent) of the authorized stock was reserved. Of some 66 designated key positions, 50 executives met the test previously referred to.

What have been the results? Have we accomplished our purposes? Have we satisfied the purpose and intent of the U.S. Congress? I believe the answer to all questions is an emphatic, "Yes."

First, the 1952 plan helped provide the imaginative drive and incentive to management for sound growth. It helped us achieve a stable organization during the very important years immediately following the mergers.

Second, a comparison of the indexes of growth beginning with 1958, the first full operating year after the last acquisition, is impressive. The base year, 1958, was also the year immediately preceding the effective year of our second option plan. You have before you, gentlemen, the statistical comparison and I will not take the time to repeat those things disclosed in the tabulation.

(The tabulation referred to follows:)

	1958	1962	Approximate percent increase
Sales	$98,623,000	$154,025,000	56
Earnings (net)	$8,628,000	$14,103,000	63
Earnings per share	$1.77	$2.88	63
Dividends	$5,850,000	$7,337,000	25
Number of shareholders	9,710	11,144	15
Shareholder equity	$55,933,000	$78,440,000	40
Number of employees	7,682	9,196	19
Wages-salaries	$41,481,000	$64,359,000	55
Taxes	$10,623,000	$16,840,000	58

Particularly significant to the economy as a whole are the growth in numbers of jobs—19 percent—which compares quite favorably with the growth in civilian jobs nationally over the same period. I believe from the report of governmental statistics I have seen of the growth in civilian jobs during this period has amounted to slightly less than 3 percent. Also significant to the economy as a whole is the increase in the personal income tax base—58 percent. The comparisons with projected 1963 results will be even more impressive.

The hearings before the House Ways and Means Committee brought forth several alleged abuses of this section of the Internal Revenue Code pertaining to restricted stock options. No doubt there have been questionable practices; questionable at least in the common interpretation of what constitutes good and ethical business judgment. I do not intend to comment on what others have done since I am not fully apprised of the circumstances under which their actions were taken. However, I am satisfied that most companies have found that options, within the strict intent of the law, are an extremely valuable incentive tool, with consequent benefits to employees, shareholders, and the Government. I am also satisfied that there have been few laws in the history of man that have not been subjected to so-called abuses, and, therefore, to this extent stock option regulations do not stand alone.

Permit me to make specific reference to some of these:

(1) The present law allows a 10-year period within which the option may be exercised. Records indicate that our executives have, in fact, exercised their options for investment or proprietary reasons and not for income. Under our plan, they must finance their own purchases; financing is not provided for by the company. I believe shortening the exercise period to 5 years, as provided in the proposed House bill, will have an opposite effect from that desired; that is, it will actually compel a selloff of shares in order to finance the full option. The proprietary interest objective would then be at least partially defeated. Furthermore, the term of an option should be long enough to encourage long-term planning by the individual in respect to both his personal future and his responsibilities to the company. Such planning will have a favorable influence on the company's operating results.

(2) The present law permits "resetting" of the option price under certain circumstances. We had decided, as a matter of internal administration, during the market downturn in 1962 that this provision would not be invoked. While I can conceive of temporarily depressed businesses or industries where the ability to reset option prices could be a real incentive to a management group, and, consequently, of potential benefit to others, we do not advocate that this "resetting" provision be retained in the law.

(3) Much concern has been expressed over the fact that executives of some companies have sold their option stock after only 6 months, or slightly longer, rather than holding it for an investment. As indicated earlier, this has not, for various reasons, been typical of our company. We are aware of only two managers presently owning fewer shares than the totals of their preoption shares plus the amounts exercised under their option. One reason may be due to the rather modest amounts of option shares granted. Another more probable reason is that our stock has been a good investment, resulting principally from the sustained efforts of key management. However, who can foretell what future economic conditions may be? Because of this, I feel that the proposed 3-year holding period will accomplish little, and may actually place an executive in an economic straitjacket.

(4) It has been frequently said that stock options give giant corporations an unfair advantage over small companies. I think the opposite is closer to the truth. Without stock options, our ability to compete for good management talent would have been seriously impaired. Conversely, we have been able to retain as surprisingly high

percentage of our executives, upward of 90 percent. Continuity of sound management has been responsible for our steady growth.

Finally, the national interest is focused directly today on the problem of stimulating economic growth in the United States. Growth of our gross national product became a major issue in the 1960 presidential campaign. There should be few citizens who do not recognize the important role that American business, large or small, must play in order to sustain the rate of growth projected. There should also be few who do not recognize that such growth will be largely dependent upon managerial capabilities. I presume the attentions of this committee and Congress will be directed toward a policy of stimulating rather than ways of repressing. There is no question, from our point of view, that the existing law fulfills this purpose, and has, in fact, provided the necessary stimulus and incentive. Reaffirmation of the 1950 Senate report underscoring the purposes of restricted stock options as an incentive device would, of itself, provide a real incentive to American business.

I wish to thank you for the opportunity of presenting our views.

The CHAIRMAN. Thank you very much, Mr. Dingeman. Any questions?

Thank you, sir.

The next witness is Mr. Emmett Wallace of the Emmett Wallace Association. Take a seat, Mr. Wallace and proceed.

STATEMENT OF EMMETT WALLACE, PRESIDENT, EMMETT WALLACE ASSOCIATES, NEW YORK, N.Y.

Mr. WALLACE. Thank you very much, sir.

I have condensed my statement and should like the privilege of submitting the full statement in the record.

The CHAIRMAN. Without objection.

Mr. WALLACE. My name is Emmett Wallace. I am president of Emmett Wallace Associates, consultants in management education and development.

I greatly appreciate the invitation of this distinguished committee to testify on the tax treatment of executive stock options. I devoted the better part of a year to studying and writing about stock options which became the subject of my doctoral dissertation. More recently, I have been an expert witness in two examinations involving applications by public utilities for permission to grant options.

My position on the tax treatment of options is as follows: The preferential treatment presently accorded options under section 421 of the code is undesirable from the point of view of the public in general and stockholders specifically. If the capital gains treatment is to be continued through the qualified stock option device, section 214 of the bill, as passed by the House of Representatives, offers a very substantial improvement. Support of this legislation, however, rests on certain assumptions whose validity seems doubtful. My study was designed to test these assumptions. Accordingly, I should like to propose for the consideration of this committee other tax provisions which rest on what I consider more realistic assumptions.

Let me review briefly the rationale of the present tax treatment. Following the Supreme Court decision in 1945 in the case of *Commis-*

sioner v. *Smith* (324 U.S. 177), there was uncertainty about the tax treatment of stock options although under a Bureau of Internal Revenue ruling in 1946 (I.T. 3795, 1946—1 CB 15) an employee exercising an option to purchase stock was considered to have received ordinary income taxable at the time the option was exercised. During the years 1946 through 1949 only 17 stock option plans were adopted according to SEC records. This was no more than the number adopted in each of the years 1944 and 1945.

To remove obstacles to the utilization of stock options, in 1950, Congress established restricted stock options which resulted in two basic changes: (1) Henceforth, the differential between option price and fair market value on date of exercise was to be treated as a capital gain provided the option and optionee met specified criteria, and (2) the tax payment was postponed until the optioned stock was sold by the optionee. This latter provision removed the double drain on the optionee of paying a tax at the same time he paid the option's exercise price.

The result is well known. During the past dozen years close to three-quarters of all listed companies have adopted restricted stock option plans.

There have been abuses. Section 214 of H.R. 8363 is designed to eliminate these abuses by making more stringent the conditions which options and optionees must meet. In the light of experience since 1950, I believe the proposed conditions are justified and needed, with one possible addition. That is, the optionee is required to hold his stock at least 3 years beyond the date of exercise of the option. He is free, however, to change his employment after he has exercised the option. Thus, an executive may be required to hold stock in a company for which he no longer works. This inconsistency might be removed by adding a requirement of continued employment after exercise of the option. It might be argued that this provision would put an undesirable restraint upon executive job movement. However, retention of executives is one of the major stated objectives of stock option plans.

The provisions of section 214 are very good provided that it is only a mending job that is desired. It is a mending job because section 214 retains the capital gain tax treatment and rests upon the same questionable assumptions which have supported this preferential treatment.

The stock option is the only incentive device which is exempt from ordinary income taxes. Salaries, cash bonuses, stock bonuses, retirement benefits are not exempt. Thus, stock options have been specifically singled out for their value in attracting and holding executives and in increasing executive interest in a corporation's success. Hence, it is logical to assume that their incentive effect should be apparent. My study was an attmept to evaluate this incentive effect.

The conclusions of the study most relevant to this committee's considerations are as follows:

1. Restricted stock options have increased executive-share ownership far beyond what it otherwise would have been, despite the subsequent sale of some shares by optionees.

2. The great majority of shares optioned by listed firms, which were the firms studied in greatest depth, have been optioned to senior executives who are also the older executives. Their work histories

showed small likelihood of future movement and the options seem to have been wasteful to the extent that they were meant to hold executives.

3. Although options have been associated with many executive moves, other factors, such as salary, position, and responsibility, have been at least as important determinants. Options seem to have played a relatively minor role in attracting executives.

4. The study shows no evidence that the use of restricted stock options results in improved performance over the long run as measured by increased share prices. Since share prices are directly related to corporation profits, it appears that if optionee-executives do in fact become more profit minded, the change in attitude is so minor as to result in no significant influence upon profits.

5. To say that there is no incentive as demonstrated by share price increases is not to deny all incentive value. Like all other forms of compensation, stock options by themselves do not have a sufficient impact to have a demonstrable effect on share prices. Similar to other forms of compensation, however, they do seem to have some incentive value. Incentive results from at least two nonproprietary qualities: (*a*) the receipt of options and their size reflect status; and (*b*) restricted stock options receive favorable tax treatment which raises after-tax income. It may be reasoned therefore that executives probably are encouraged to work harder or more effectively before options are granted in order to be recognized for the receipts of options or to earn larger options.

The results of another study are also relevant. This study demonstrated that purely on a direct-cost basis, incentive value aside, it costs corporations more to increase an executive's after-tax income through stock options than through salary or bonus increases unless the executive earns more than $100,000 a year.[1] The higher cost results from the fact that salaries and bonuses are deductible expenses for the corporation, whereas the differential between option price and market value on date of exercise is not deductible.

The significance is that options have been a relatively costly form of compensation because most of them have been granted to executives who earn less than $100,000. The added cost has been borne by the shareholders. Generally, however, shareholders are not aware of the cost since there is no impact upon the corporation's income statement, but rather only an unnoticed dilution of stock.

Finally, let me turn to the implications for tax policy. It is a widely accepted principle that tax laws should be adjusted to encourage a certain type of service or activity which is in the public interest and which is not adequately served by the market. The preferential tax treatment for stock options was originally justified as uniquely improving incentive and the ability of firms to attract and retain executives. Yet there is little or no evidence that they have, in fact, fulfilled these purposes, at least for the larger corporations which were the subject of my study. The evidence of gain to the economy is meager. There seems, therefore, to be little justification for the preferential capital gain tax treatment which has stimulated their use, even with the more stringent conditions embodied in section 214.

[1] Daniel M. Holland and Wilbur G. Lewellen, "Probing the Record of Stock Options," Harvard Business Review, March–April 1962, p. 132.

As has been pointed out, stock options have an incentive value comparable to other forms of compensation. For smaller firms, also, stock options may be especially valuable as a contingent compensation device which conserves cash, since no cash outflow accompanies their use similar to salary or bonus payments. For small, growing companies this conservation of cash can be critical. Accordingly, provision should be made to preserve the incentive value of options that does exist. It seems desirable, as a matter of public policy, for management to have at hand as large a number of incentive devices as possible. Consequently, it is suggested that the use of (nonrestricted) stock options should be facilitated.

Total elimination of the restricted status of stock options by the erasure of section 421 of the code would return us to the pre-1950 tax law and would discourage the use of stock options, just as their use was discouraged before 1950. This same discouragement in the future would not conform to the suggestion that the use of options should be facilitated.

I therefore suggest that legislation should be adopted as follows: elimination of the capital gain tax feature presently accorded restricted stock option, but continuation of the provisions permitting deferment of taxpayment until the shares are sold. This privilege should be contingent upon two conditions: (1) Optionees should be employees at the time of grant, at the time of exercise, and during the interim; and (2) the option price should be 100 percent of the market value on the date of grant. There need be no waiting period prior to exercise nor a holding period following exercise in order for the optionee's income to qualify for tax deferment.

The gain prior to exercise would be taxed as ordinary income at the time of sale of the underlying shares by optionee. The option company would treat the optionee's gain as a deductible expense at the time of exercise. The net effect to the Government would be deferment of receipt of taxes.

Is the deferment justified? An analysis of the probable results supports the tax deferment suggested.

1. The double drain on the optionee's resources at the time of exercise will be avoided. This obstacle to the use of stock options which existed prior to 1950 will still be overcome and the use of stock options by management as one of a battery of available incentive devices will be facilitated.

2. Optionees will have incentive for early exercise when share price appreciation is anticipated. Early exercise will result from a desire to minimize gain and therefore ordinary taxable income prior to exercise. This will increase their stake in their companies, a desired result under present legislation.

3. Optionees will have incentive to hold shares in order to defer possibly large taxes on the ordinary income from option gains, which taxes will become payable when the shares are sold.

In short, I am suggesting that stock option gains prior to exercise no longer be taxed as capital gains. There is no evidence of the country's social or economic gain resulting from the use of restricted stock options. In order to take advantage of options for the somewhat more limited incentive value they hold and for their value as a contingent compensation device, tax deferment until sale of the

optioned shares by optionees should be continued. Thus, the original objectives of Congress will have better chance of attainment and the unjustified preferential tax treatment of corporation executives, as a group apart from others, will be removed.

(The full statement of Mr. Emmett Wallace follows:)

STATEMENT OF EMMETT WALLACE, NEW YORK, N.Y.

My name is Emmett Wallace. I am president of Emmett Wallace Associates, consultants in management education and development.

I greatly appreciate the invitation of this distinguished committee to testify on the tax treatment of executive stock options. I consider this an honor and an opportunity. I devoted the better part of a year to studying and writing about stock options which became the subject of my doctoral dissertation. More recently I have been an expert witness on behalf of the public utility commissioner of the State of Oregon in two examinations involving applications by public utilities for permission to grant options.

My position on the tax treatment of stock options is as follows:

The preferential treatment presently accorded options, under section 421 of the code, is undesirable from the point of view of the public in general and stockholders specifically. If the capital gains treatment is to be continued through the qualified stock option device, section 214 of the bill, as passed by the House of Representatives, offers a very substantial improvement. Support of this legislation, however, rests on certain assumptions whose validity seems doubtful. My study was designed to test these assumptions. Accordingly, I should like to propose, for the consideration of this committee, other tax provisions which rest on what I consider more realistic assumptions.

First, let me review, briefly, the rationale of the present tax treatment. Following the Supreme Court decision in 1945 in the case of *Commissioner* v. *Smith* (324 U.S. 177), there was uncertainty about the tax treatment of stock options, although, under a Bureau of Internal Revenue ruling in 1946 (I.T. 3795, 1946, 1 CB 15), an employee exercising an option to purchase stock was considered to have received ordinary income taxable at the time the option was exercised. During the years 1946 through 1949, only 17 stock option plans were adopted according to Securities and Exchange Commission records. This was no more than the number adopted in each of the years 1944 and 1945.

To remove obstacles to the utilization of stock options, in 1950, Congress established restricted stock options which resulted in two basic changes: (1) henceforth, the differential between option price and fair market value on date of exercise was to be treated as a capital gain, provided the option and optionee met specified criteria and (2) the tax payment was postponed until the optioned stock was sold by the optionee. This latter provision removed the double drain on the optionee of paying a tax at the same time he paid the option's exercise price.

The result is well known. During the past dozen years, close to three-quarters of all companies listed on the New York and American Stock Exchanges have adopted restricted stock option plans.

There have been abuses. Section 214 of H.R. 8363 is designed to eliminate these abuses by making more stringent the conditions which options and optionees must meet. In the light of experience since 1950, I believe the proposed conditions are justified and needed, with one possible addition. That is, the optionee is required to hold his stock at least 3 years beyond the date of exercise of the option. He is free, however, to change his employment after he had exercised the option. Thus, an executive may be required to hold stock in a company for which he no longer works. This inconsistency might be removed by adding a requirement of continued employment after exercise of the option. It might be argued that this provision would put an undesirable restraint upon executive job movement. However, retention of executives is one of the major stated objectives of the legislation and of practically all the stock option plans.

The provisions of section 214 of H.R. 8363 are very good provided that it is only a mending job that is desired. It is a mending job because section 214 retains the same basic tax treatment as heretofore—capital gains—and rests upon the same questionable assumptions which have supported this preferential treatment.

The stock option is the only incentive device which is exempt from ordinary income taxes. Salaries, cash bonuses, stock bonuses, retirement benefits are not exempt. The Senate Finance Committee justified the special treatment in the following words:

"Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business, to retain the services of the executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation." [1]

Thus, stock options have been specifically singled out for their value in attracting and holding executives and in increasing executive interest in a corporation's success. Hence, it is logic to assume that their incentive effect should be apparent. My study was an attempt to evaluate this incentive effect.

As have others, I have examined the provisions of stock option plans and the extent to which optionees have retained shares after exercise of the options. However, these considerations provided only a point of departure for my study. From a sample of close to 600 corporations, I examined the stock option practices of over 50 in some detail. The personal stock transactions and work histories of several hundred executives were reviewed. Comparisons were made with what had happened in terms of stock ownership and executive turnover in similar firms not granting options. A detailed study was made of share price histories from 1946 until 1960 for 37 firms that had granted options, and statistically significant differences were sought in comparisons with 37 paired firms which had not granted options. Data were illuminated by interviews of 40 executives in the firms studied.

IMPACT OF STOCK OPTIONS ON PROPRIETARY INTEREST

Restricted stock options have facilitated increased stock purchases by executives far beyond what they otherwise would have been. Some of these executives disposed of most of the stock not long after its purchase; most optionee-executives have sold at least some stock. This point does not need further elaboration since the Secretary of the Treasury, Mr. Dillon, provided ample supporting evidence (pp. 186–187 of these hearings).

Several additional observations are appropriate:

1. The extent of disposal of optioned shares seems to be directly related to the size of options. The larger the options, above a certain level relative to an optionee's income, the more shares that seem to be sold.
2. One of the major reasons for selling shares has apparently been the need of optionees to finance the exercise of succeeding options.
3. If the 3-year shareholding period is adopted, as proposed in section 214 of H.R. 8363, it may result in smaller options since optionees will not be so readily able to utilize the proceeds from the sale of shares obtained through one option to finance the exercise of another option. This may have the salutary effect of making the occasional excessively large options relative to executive salaries somewhat less attractive.

IMPACT ON ATTRACTING EXECUTIVES

Let us now examine how effective stock options have been in enticing executives to move from one job to another in which they may be used more productively. This is the second use of stock options cited in the 1950 Report of the Committee on Finance.

There have been many random observations, especially by executive placement specialists, in support of the notion that options are a very significant factor affecting executive moves.[2] Numerous instances are cited of the use of options to attract executives and, conversely, of the failure of firms to attract key personnel for lack of stock options. Also noted is the loss of key personnel by companies which offer no options. The assumption is often made that the decision to shift from one company to another or to remain with a company has been predicated upon both the availability and size of options.

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[1] Report of the Committee on Finance, U.S. Senate, to accompany H.R. 8920, 81st Cong., 2d sess. (1950), S. Rept. 2375, p. 90.

[2] See, for example, Cahill, Gordon, Reindel & Ohl, Brief and Proposed Findings and Conclusions of Middle South Utilities, Inc., in Support of Application-Declaration With Respect to Adoption of Restricted Stock Option Plan, submitted to the Securities & Exchange Commission Dec. 1, 1959, ref. file No. 70–3777.

This disregards the possibility that other motives might have impelled executives to move or not to move and that the availability and size of options might have been subsidiary considerations. Indeed, many surveys of management incentives point to a complex web of motivations in which money by itself appears to be relatively unimportant, but in which money contributes to an unknown degree to the attractiveness of nonfinancial factors. Thus, executives switch jobs to obtain more responsibility, to improve their chances for advancement, to change activity, and to escape from objectionable personal relationships and management policies.

But these observations are, perhaps, too general. We must attempt to determine if stock options, as distinct from other forms of compensation, have a bearing on executive moves. Pertinent evidence bearing on this issue was provided by the Securities and Exchange Commission hearings on the application of Middle South Utilities for permission to grant stock options: The president of Electric Bond & Share testified that options had been an important factor in inducing four executives to join Electric Bond & Share subsidiaries. On cross-examination, he revealed that they also received salary increases, they had joined larger companies, and they had obtained higher ranking positions.[3] Executives whom the writer interviewed cited relatively few persons who had been attracted with the bait of stock options. In many of the instances cited, though by no means all, they suggested that additional incentives besides options had played a part.

Thus, the value of options as a device to attract executives is not clear-cut. One factor that makes assessment difficult is that executives mobility is so small that many corporations do not experience it. Also, mobility is especially low in the upper echelons of management which receives options for most of the shares optioned. One study revealed that less than 2 percent of all executives change companies in a given year.[4] In this same study, it was found that 87 percent of the executives who had already become officers did not change jobs.[5] Accordingly, it is difficult to generate a mass of data from which one can generalize. It seems that at best one must rely on bits and pieces of evidence that reflect the value of options as a device to attract executives.

There are several small items of evidence which raise questions as to the alleged value of options in attracting executives:

1. There are still many firms which do not offer options. Most of these are direct competitors of option companies. Some of them have attracted executives without options. The executives of several of them were interviewed and stated that they felt at no competitive disadvantage in seeking management talent for lack of options.

2. Approximately one-third of the original restricted stock option plans provided for one offer only.[6] Thus, only individuals employed at the time of grant could qualify, and the options could not be offered to prospective employees.

3. Many option companies which offer options in more than one grant still do not contemplate the attraction of executives with options. This objective is omitted from the stated purposes of their restricted stock option plans.

4. Still other firms which state that options will be used to attract executives do not use them for this purpose. Thus, Continental Can Co., Inc., urged approval of an amendment to its stock purchase plan No. 2 in April 1960 in order to be able to offer options to new employees.[7] Yet Continental Can's proxy statement revealed that no new options had been granted in the preceding 3 years although unoptioned shares had been available. This indicates that either options were not necessary to attract executives or that no new executives were hired during 3 years of substantial growth. Similarly, United States Steel Corp. granted no options January 1, 1959, through February 1, 1960.[8] As a matter of fact, only one of the firm's top executives had joined the company since the inception of the first stock option plan, in 1951. This was their general

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[3] Securities and Exchange Commission, Proposed Findings and Conclusions of the Division of Corporate Regulations, In the Matter of Middle South Utilities, Inc., File No. 70-3777 (May 10, 1960, pp. 22-24).

[4] David R. Roberts, "Executive Compensation," Quarterly Journal of Economics, May 1956, p. 271.

[5] Ibid., p. 279.

[6] National Industrial Conference Board, Executive Stock Ownership Plans (1951), p. 11.

[7] Continental Can Co., Inc., proxy statement, Apr. 26, 1960.

[8] United States Steel Corp., proxy statement, Mar. 21, 1960.

counsel who had been associated with United States Steel for many years as outside legal counsel.

5. Executives who were interviewed, whether from option or nonoption companies, were in agreement on one point: Their firms had a policy of promoting from within. Most of the option companies had not had occasion to grant options in order to attract new executives.

6. Henry Ford had stated that options were necessary to attract "a dozen or so men without whose guidance this company certainly would not be where it is today."[9] The rejuvenation of this company is a dramatic example of the value of attracting executive talent. Yet were they attracted by options? According to public records which I have reviewed on 20 of the top 26 executives as of mid-1960, Mr. Ford excepted (I can find no public data on the other 6), 18 joined the company prior to 1950, 1 joined in 1951, and 1 joined in 1955. So 18 joined before restricted stock options were established by Congress. Only one man could have been attracted by a stock option in hand, since the company itself granted no options until 1953.

This evidence seems to indicate that the problem of attracting executives is qualitative rather than quantitative. The need to go outside an organization to find an executive is infrequent relative to the number of executive positions.

Although the frequency of executive moves is small, it is important that the proper executive be found for each open position. The general supply of executives suitable for any position declines as the demands of that position increase in terms of executive qualities. The job specifications for some positions may be met by only a few individuals, and among these only one or two may be willing to consider a move. At such times, a stock option may be the necessary tool to pry the right executive loose from another job.

In short, there is no proof that stock options have the value claimed for attracting executives to new positions. They are not generally applied for this purpose and other more conventional incentives would seem to be equally or more powerful. But an option may be extremely important when it is necessary to attract a particular executive, when the range of choices open to the firm is limited, and when potential profit is a sufficiently strong motivation for the executive who would not otherwise take the position.

HOLDING POWER OF OPTIONS

Let us examine, now, the holding power of options. The writer attempted an assessment of this by a review of those who are getting options. While there is no public record of all executives who are granted options, the record does reveal the size of options for the top executives who receive the largest options and whom, presumably, the firms most wish to retain.

Table 1 gives data on 12 companies. The companies were selected on a random basis, although selection was necessarily limited by the availability of data. What do the data in table 1 mean? There follow two examples:

> The 20 top optionees of Bethlehem Steel received approximately one-third of the optioned stock. Their average age at the time of the latest grant was 60 years. Fifteen of them were over 55. Their average length of service was almost 35 years. On the average one out of two had previous employers.
>
> Continental Baking Co.'s nine top optionees received more than half the optioned stock. They averaged almost 60 years of age; six were over 55. They averaged almost 35 years of service with Continental and one previous employer.

In general, it is a handful of older and higher ranking executives who have received a significant portion, if not a majority, of the options granted in most of the firms studied. Many of the optionees were over 55, which is often loosely accepted as an age when a man stops thinking about moving to another company. These optionees have grown with their firms, which generally try to promote from within rather than to seek executives from other firms. A question might be raised as to whether options would have been necessary to hold them.

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[9] See remarks before annual meeting of Ford stockholders, May 19, 1960. Also see "Stock Options Are in the Public Interest," Harvard Business Review, July–August 1961.

TABLE I.—*Age and work experience of executives granted options by 12 companies*

Company	Number of optionees studied	Average age at time of latest known grants	Number of optionees age 55 and over	Average years of service at time of latest known grant	Average age on joining company	Average number of prior employers	Grants to optionees at percent of company options [1]	Reference years for col. 8
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
The American Metal Co.	9	47.6	0	22.8	24.8	0.89	(2)	1952-56
Bethlehem Steel Corp.	20	60.6	15	34.5	26.1	.50	33	1957-59
Cities Service Oil Co.[3]	11	57.9	8	32.7	25.2	.55	(4)	----------
Continental Baking Co.	9	59.4	6	34.3	25.1	1.0	(5)	1954-55
Corn Products Co.	16	53.0	7	22.6	30.4	.64	74	1951-56
Freeport Sulphur Co.	9	52.1	4	22.0	30.1	1.0	36	1954-58
Liggett & Myers Tobacco Co.	10	53.4	7	26.9	26.5	.78	53	1956-59
Lone Star Cement Corp.	8	62.7	8	31.1	31.6	(4)	19	1952-55
Chas. Pfizer & Co., Inc.	12	49.2	1	16.5	32.7	1.2	(6)	1952-58
Sinclair Oil Corp.	17	56.5	14	28.6	27.9	.69	(2)	1951-59
United States Steel Corp.	60	53.7	29	20.9	32.8	1.42	(7)	1951-56
West Virginia Pulp & Paper Co.	14	50.4	5	(8)	(9)	1.25	(10)	1952-56

[1] Executives who joined firms which were later absorbed by the parent companies in col. 1 are considered as having joined their companies at the earlier date. Accordingly, they were not considered as having changed employers.

[2] About 20.

[3] The data for Cities Service Oil Co. are as of Apr. 28, 1958, when the firm's 1st restricted stock option plan was approved by stockholders. The 11 top executives were eligible for options although it is not known what proportion they received of the total shares optioned.

[4] Not available.

[5] More than 50.

[6] Minor.

[7] More than 40.

[8] About 23.4.

[9] About 27.

[10] More than 33.

Sources: Company proxy statements; form 4, statements submitted monthly by officers to the SEC listing security transactions; "Who's Who in America; Who's Who in Commerce and Industry."

It might well be argued that the evidence is not conclusive since it is impossible to tell what would have happened if there had been no options. This is a legitimate criticism. However, it is suggested here only that some evidence is presumptive though certainly not conclusive, that options do not hold executives who would otherwise resign.

This evidence receives support, however, by examination of the executive resignations from comparable firms which have not offered options. The pattern of executive ages, length of service, and executive turnover in nonoption companies does not seem to differ significantly from the option companies. Executives of nonoption companies who were interviewed confirmed the impression of small loss of executives through resignations. Indeed, the best evidence that nonoption companies do not suffer from decimation of their executive ranks for lack of options is the fact that they have not felt obliged to adopt option plans to stem an incipient outflow. It may be that they employ other incentive devices such as deferred profit sharing, stock purchase, and retirement plans. The point is that it does not appear that stock options have a unique holding effect which other incentive devices do not have.

This is not to say that options have never been effective in holding executives. They undoubtedly have been in specific situations when executives have actually been attracted to other corporations by the offer of competing options. However, options certainly give no guarantee of holding executives, as numerous instances attest.

In short, there is little evidence to support the notion that options have great value in attracting and holding executive talent. Many instances can be cited in which options were received by executives who took new positions. But what other influences of salary, position, prestige, responsibility, etc., might have been equally, or more, important determinants? Executives join firms which offer no options. Executives leave firms and lose their options, sometimes, although not always, compensated by the grant of new options by their new employers. There are numerous examples of the failures of options to attract and to hold executives.

As has been previously pointed out, options are used only infrequently to attract executives. Most firms have used options to hold, rather than to attract, executives. Senior executives have been the main beneficiaries. Yet it is just these executives who show the least likelihood of moving. To a very large degree, therefore, options may be wasteful if used for these purposes. Although they are granted to a mass of executives, their impact is highly selective; they seem to influence only a portion of the small number of executives who are prone to move. It would seem that on the basis of the data examined the use of options is not highly significant in terms of attracting or holding executives.

IMPACT ON EXECUTIVE INCENTIVE

Restricted stock options are advocated to incite executives to greater effort and improved management by rewarding them through share price appreciation. Critics assert, however, that share prices offer a poor measure of executive performance. Thus, it is said, the value of an option is determined to a large extent by overall stock market price movements, independent of the economic performance of an individual company.[10] Such movements are reflected by changes in price-to-earnings ratios—a rise of nearly 200 percent from 1950 to 1960 and a decline of approximately 25 percent during 1962. Also, profits which are a determinant of share prices are said to be fortuitous since there are many factors; such as taxes, economic conditions, and Government spending, beyond the control of management which affect profits.

Accordingly, executive-optionees may gain, or fail to gain, sometimes out of proportion to the skill or effort which they expend. However, this need not rule out the use of options. Profit-sharing plans can be said to suffer from the same criticism. Profits can go up or down and executives who work in the hope of gain from stock options are taking a risk that profits and share prices may decline despite hard work and the exercise of keen judgment. But this points up the ability of options to reproduce entreprenurial risk and perhaps incentive for the management of publicly owned corporations. Of course, the optionee's risk is not the same as the owner's since he is not risking his money, only potential profit. Nevertheless, granted that there are factors affecting profits which

[10] Erwin N. Griswold, "Are Stock Options Getting Out of Hand?" Harvard Business Review, November–December 1960, p. 49.

are outside the control of management, executives should be encouraged to take advantage of favorable factors and to soften the influence of unfavorable factors, which is the incentive which entrepreneurs have.

Much of the risk to optionees was removed in 1954 when Congress amended the legislation to permit reduction in option prices if the average fair market value of optioned stock remained for 12 months at less than 80 percent of the value on date of grant. Only a minority of companies has invoked this special rule, however, practically all since late 1957. Other companies have avoided option price reductions while achieving the same end, by making two or more grants of options which bear successively lower prices. The condition in section 214 of H.R. 8363 which forbids these practices is necessary.

Perhaps more important is the assessment of how effective stock options have been in increasing executive incentive to work harder and more effectively. Optionees are rewarded through share price appreciation. Accordingly, share price performance should reflect the impact of options on executive incentive.

Since the share prices of most firms rose during the 1950's, the incentive value of restricted stock options cannot be judged merely from the fact of share price increases. Many firms which granted no options shared in these increases. If options do have a unique incentive effect, however, their use should be reflected by a comparison of the performance of option companies with nonoption companies. This does not mean that each company which adopts an option plan will improve its performance or perform better than a nonoption company, for poor management or unfortunate events may offset the improved performance resulting from the incentive effect of the options. But it does mean that, given a sufficiently large sample of firms and thereby distributing management differences and chance events over a large number of companies, the option companies should show a generally greater performance improvement than the nonoption companies.

Paired comparisons of option and nonoption companies' share price performance formed the main basis of this part of my study—37 option companies were paired against 37 nonoption companies. The paired companies were as nearly alike as possible in terms of product line and sales volume in 1950, when restricted stock options were first adopted. Each option company selected had to have had at least 5 years' experience with options since then. No nonoption company was included whose management held more than a very minor portion of the shares outstanding. Thus, an attempt was made to compare firms that were as much alike as possible in all respects except their use of stock options and the existence of a proprietary interest on the part of management. In this way, the nonoption companies served as a control group.

Share price performance was compared over a 14-year period, almost half of which was before the stock option plans were adopted by most of the companies. Thus, not only were comparisons between option and nonoption companies possible for the period after the adoption of option plans, but the possible impact of options on the subsequent rates of share-price appreciation was examined in the light of rates of appreciation before the adoption of plans.

There were 38 pairs of option and nonoption companies since 2 of the 74 firms were paired twice. The results can be summarized quite briefly. There seemed to be no significant differences in share-price appreciation between option and nonoption firms. While 16 option companies showed performance significantly superior to their mates, 5 did no better and 17 performed significantly worse. Generally, the relatively greater share-price increases of either the option or nonoption companies, were associated with higher rates of share-price increases established prior to adoption of the stock option plans, by the option companies.

This study shows no evidence that restricted stock options have an incentive effect which results in improved performance as measured by increased share prices of firms which grant restricted stock options. It is true that many other factors affect share prices. But if options had a true special incentive effect, the share prices of a group of option firms should increase significantly more than the prices of a group of comparable nonoption firms; the factors other than stock options which influence share prices can be considered as chance factors which cancel out because they act upon option and nonoption firms alike.

If optionee-executives do become better managers and more profit-minded, the changes in performance and attitude are so minor as to result in no significant influence upon profits. Stock options, therefore, give no evidence of an unusual or unique incentive based upon the proprietary interest which they are said to give executives.

CONCLUSIONS OF MY STUDY

The conclusions of the study, based on evidence reviewed above, are as follows:

(1) Restricted stock options have increased executive-share ownership far beyond what it otherwise would have been, despite the subsequent sale of some shares by optionees.

(2) The great majority of shares optioned by listed firms, which were the firms studied in greatest depth, have been optioned to senior executives who are also the older executives. Their work histories showed small likelihood of future movement and the options seem to have been wasteful to the extent that they were meant to hold executives.

(3) Although options have been associated with many executive moves, other factors, such as salary, position, and responsibility have been at least as important determinants. Options seem to have played a relatively minor role in attracting executives.

(4) The study shows no evidence that the use of restricted stock options results in improved performance over the long run as measured by increased share prices. Since share prices are directly related to corporation pofits, it appears that if optionee-executives do in fact become more profit-minded, the change in attitude is so minor as to result in no significant influence upon profits.

(5) To say that there is no incentive as demonstrated by share price increases is not to deny all incentive value. Like all other forms of compensation, stock options by themselves do not have a sufficient impact to have a demonstrable effect on share prices. Similar to other forms of compensation, however, they do seem to have some incentive value. Incentive results from at least two nonproprietary qualities (*a*) the receipt of options and their size reflect status; and (*b*) restricted stock options receive favorable tax treatment which raises aftertax income. It may be reasoned, therefore, that executives probably are encouraged to work harder or more effectively before options are granted in order to be recognized for the receipt of options or to earn larger options.

The results of another study are also relevant. This study demonstrated that purely on a direct cost basis, incentive value aside, it costs corporations more to increase an executive's aftertax income through stock options than through salary or bonus increases unless the executive earns more than $100,000 a year.[11] The higher cost results from the fact that salaries and bonuses are deductible expenses for the corporation, whereas the differential between option price and market value on date of exercise is not deductible.

The significance is that options have been a relatively costly form of compensation because most of them have been granted to executives who earn less than $100,000. The added cost has been borne by the shareholders. Generally, however, shareholders are not aware of the cost since there is no impact upon the corporation's income statement, but rather only an unnoticed dilution of stock.

IMPLICATIONS FOR TAX POLICY

Finally, let me turn to the implications for tax policy. The tax laws are often adjusted to encourage a certain type of service or activity which is in the public interest and which is not adequately served by the market. President Kennedy put it this way in his special message on taxes of April 20, 1961: "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." But he went on to say, immediately thereafter: "But many of the preferences which have developed do not meet such a test and need to be reevaluated in our tax reform program."

The preferential tax treatment for stock options was originally justified as uniquely improving incentive and the ability of firms to attract and retain executives. Yet there is little or no evidence that they have, in fact, fulfilled these purposes, at least for the larger corporations which were the subject of my study. The evidence of gain to the economy is meager. There seems therefore to be little justification for the preferential capital gain tax treatment which has stimulated their use, even with the more stringent conditions embodied in section 214.

[11] Daniel M. Holland and Wilbur G. Lewellen, "Probing the Record of Stock Options," Harvard Business Review, March–April 1962, p. 132.

If the justification for preferential tax treatment is to rest only upon the belief that tax rates are too high, and this was one of the supporting arguments in 1950, then it seems only equitable to offer similar relief to other groups besides corporation executives. Tax treatment which favors corporation executives assumes either that high taxes discourage corporation executives more than other groups or that a greater flow of executive talent must be attracted from other groups to corporations. There is no evidence to support the assumption that high taxes discourage corporation executives more than civil servants, teachers, doctors, lawyers, or scientists, to mention some of the other groups. Nor are we concerned with encouraging a greater flow of talent into executive positions in business. The present-day concern lies rather in developing more teachers, scientists, and capable public servants. The remedy for high tax rates is wholesale revision of our tax laws, not piecemeal relief for prefererd groups.

As has been pointed out, stock options have an incentive value comparable to other forms of compensation. For smaller firms, also, stock options may be especially valuable as a contingent compensation device which conserves cash, since no cash outflow accompanies their use similar to salary or bonus payments. For small, growing companies this conservation of cash can be critical. Accordingly, provision should be made to preserve the incentive value of options that does exist. It seems desirable, as a matter of public policy, for management to have at hand as large a number of incentive devices as possible. Consequently, it is suggested that the use of (nonrestricted) stock options should be facilitated.

Total elimination of the restricted status of stock options by the erasure of section 421 of the code would return us to the pre-1950 tax law and would discourage the use of stock options, just as their use was discouraged before 1950. This same discouragement in the future would not conform to the suggestion that the use of options should be facilitated.

I therefore suggest that legislation should be adopted as follows: elimination of the capital gain tax feature presently accorded restricted stock options, but continuation of the provision permitting deferment of tax payment until the shares are sold. This privilege should be contingent upon two conditions: (1) Optionees should be employees at the time of grant, at the time of exercise, and during the interim; and (2) the option price should be 100 percent of the market value on the date of grant. There need be no waiting period prior to exercise nor a holding period following exercise in order for the optionee's income to qualify for tax deferment.

The gain prior to exercise would be taxed as ordinary income at the time of sale of the underlying shares by optionee. The option-company would treat the optionee's gain as a deductible expense at the time of exercise. The net effect to the Government would be deferment of receipt of taxes.

Is the deferment justified? An analysis of the probable results supports the tax deferment suggested:

(1) The double drain on the optionee's resources at the time of the exercise will be avoided. This obstacle to the use of stock options which existed prior to 1950 will still be overcome and the use of stock options by management as one of a battery of available incentive devices will be facilitated.

(2) Optionees will have incentive for early exercise when share price appreciation is anticipated. Early exercise will result from a desire to minimize gain and therefore ordinary taxable income prior to exercise. This will increase their stake in their companies, a desired result under present legislation.

(3) Optionees will have incentive to hold shares in order to defer possibly large taxes on the ordinary income from option gains, which taxes will become payable when the shares are sold.

In short, I am suggesting that stock option gains prior to exercise no longer be taxed as capital gains. There is no evidence that the preferential tax treatment which Congress granted over 13 years ago has resulted in any greater executive identification for, and long-term interest in, American corporations. There is no evidence of the country's social or economic gain resulting from the use of restricted stock options. In order to take advantage of stock options for the somewhat more limited incentive value they hold and for their value as a contingent compensation device, tax deferment until sale of the optioned shares by optionees should be continued. Thus, the original objectives of Congress will have better chance of attainment and the unjustified preferential tax treatment of corporation executives, as a group apart from others, will be removed.

Mr. WALLACE. In my full statement there is more background on the findings in my study and how these conclusions were reached for your perusal.

I thank you very much.

The CHAIRMAN. Thank you, Dr. Wallace.

Any questions?

Thank you very much, sir.

The next witness is Mr. H. Clay Johnson of the National Board of Fire Underwriters.

Mr. JOHNSON. Mr. Chairman, in the interest of saving the committee's time, I would like to read a very short statement which will take only about 4 minutes, and I would like to request that my fuller statement be included in the record.

The CHAIRMAN. Without objection.

STATEMENT OF H. CLAY JOHNSON, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL OF THE ROYAL-GLOBE INSURANCE COS., APPEARING ON BEHALF OF THE NATIONAL BOARD OF FIRE UNDERWRITERS

Mr. JOHNSON. Mr. Chairman, my name is H. Clay Johnson, and I am executive vice president and general counsel of the Royal-Globe Insurance Cos.

I am appearing on behalf of two capital stock insurance trade associations, with a combined membership of over 300 companies, to request an amendment to the proposed tax bill which would eliminate a glaring inequity in reference to the privilege of filing consolidated corporate tax returns.

When the House Ways and Means Committee made its report on the bill, it said at page 118:

> Your committee did not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of the foregoing multiple surtax exemptions and the definition of a group eligible to file a consolidated return.
>
> Moreover, your committee is not aware of any situations in which the discrepancies in the two definitions would create a hardship. If it develops, however, that the differing definitions create a substantial hardship for certain groups subject to the penalty tax which cannot file consolidated returns, the decision would have to be reconsidered and adjustments made to the extent possible.

I would like to emphasize that the Ways and Means Committee proposed not just a reconsideration but actual adjustments to the extent possible to relieve substantial hardships falling upon certain groups subject to the penalty tax which could not file consolidated returns.

While we were afforded an opportunity to discuss our problem with the staff of the Ways and Means Committee, it was not possible to gain an appearance before that committee since the provision in question was inserted in the bill only after the public hearings were closed.

We assume the above-quoted comments in that committee's report were prompted, at least in part, by their recognition of the lack of opportunity for them to hear of such resulting inequities.

We believe that certain groups of fire and casualty insurance companies, for which I am spokesman, are directly in the category with which the Ways and Means Committee were concerned since, under

the bill, they would be subjected to the penalty tax and yet not permitted to file consolidated returns.

The groups to which I refer are those which contain one or more foreign insurers along with affiliated domestic insurance companies. By leaving unchanged section 1504 of the code, the bill would not make any correction in the present law which says that a foreign corporation is not an "includible" corporation for purposes of filing consolidated returns.

Thus, the foreign affiliated groups for which I speak would be unable to offset the disadvantage of the penalty against the benefits of a consolidated return, such as freedom from taxation of intercorporate dividends and other intercorporate transactions, as well as the offsetting of profits and losses among the affiliated companies.

Conversely, domestic affiliated groups which compete in the same insurance market would, after repeal of the present 2 percent penalty tax, be permitted to enjoy these benefits of a consolidated return at no extra tax cost.

By not according equal tax treatment as between foreign affiliated groups and domestic affiliated groups, the bill would therefore not only create the type of "hardship" which the Ways and Means Committee left for later consideration and "adjustment * * * to the extent possible," but we believe the bill would also violate the obligation of the United States under its tax treaties with other nations.

As an example, I would cite article XXI of the Income Tax Treaty between the United States and Great Britain which provides in effect that British corporations shall not be subjected in the United States to "other and more burdensome taxes" than those which are imposed on U.S. corporations.

In our view, denial to foreign affiliated insurance groups doing business in the United States of the privilege of filing a consolidated return, while still imposing on them the proposed penalty provisions, would clearly make their resulting tax "more burdensome" than that imposed on their domestic counterparts.

To cure this obvious defect in the bill, we propose a very simple remedy; viz, that section 1504 be amended to include at the end of paragraph (b) (3) the words "other than foreign insurance corporations subject to taxation under section 831."

This amendment would not change the current tax base of foreign insurers which conduct business in the United States as a group since it would merely permit the same income to be reported on a consolidated return rather than in separate returns, thus placing foreign affilated groups in a position of tax parity with domestic affiliated groups.

Briefly stated, the IRC requires all stock fire and casualty insurance companies which are qualified to do business in the United States to report their income on the basis of the annual statements which they file with the supervisory authorities in the various States where they are admitted.

By referring to section 831 our proposed amendment would thus confine the consolidated return privilege to foreign affiliated insurance groups comprised entirely of companies which file annual statements with the State supervisory authorities and pay Federal tax on the basis of the income reflected therein. This would create no complications

for the Treasury Department since it would embrace the same taxable income which is already being reported on separate returns.

The foreign affiliated group of insurance companies by which I am employed can be cited as an example. The parent corporation is the Royal Insurance Co., a British corporation. The operations of the group are conducted in the United States through British corporations qualified to do business therein and also through subsidiary U.S. corporations. Each is presently a separate U.S. taxpayer.

The U.S. branches of the foreign insurers presently file Federal tax returns and pay taxes at full corporate rates on all income derived from U.S. sources. The domestic subsidiaries also presently file Federal returns and pay taxes on income derived from all sources. Under our proposed amendment this affiliated group would be permitted to embrace all of its taxable income in one consolidated return. As already stated, we believe this amendment to be necessary not only to prevent an undesirable inequity but also to prevent an illegal violation of existing treaties.

We respectfully request that your committee adopt the amendment we have suggested.

Thank you, Mr. Chairman.

(The full prepared statement of Mr. Clay Johnson follows:)

STATEMENT OF H. CLAY JOHNSON ON BEHALF OF THE NATIONAL BOARD OF FIRE UNDERWRITERS WITH RESPECT TO THE PROPOSAL IN H.R. 8363 TO REPEAL THE TAX ON CONSOLIDATED RETURNS AND TO LIMIT SURTAX EXEMPTIONS

Mr. Chairman, my name is H. Clay Johnson, and I am executive vice president and general counsel of the Royal-Globe Insurance Cos. I am appearing today on behalf of the 190 stock insurance member companies of the National Board of Fire Underwriters. I am also authorized to say that our position and the proposed amendment we are submitting have the full support of the 128 stock insurance member companies of the Association of Casualty & Surety Companies. I am addressing my remarks solely to the matter of the inequitable results of the proposed legislation on foreign insurance corporations which conduct business in the United States as a group with one or more affiliated domestic insurance corporations.

The specific inequity which we are seeking to correct may be briefly stated as follows: A foreign insurance corporation will be deemed a member of an affiliated group for the purpose of denying it a surtax exemption, but the same foreign corporation will not be considered a member of an affiliated group for the purpose of determining eligibility to join in a consolidated return.

This problem is created (1) by the proposed repeal of the 2-percent penalty for filing consolidated returns under section 222 of the bill and the proposed reduction of surtax exemption in the case of certain controlled corporations under section 223 of the bill; and (2) the present provisions of section 1504(b)(3), which prohibit the inclusion of a foreign corporation as a member of an "affiliated group" as the term is defined in that section.

There are at least 10 affiliated groups of member companies composed of both foreign and American insurers which would be adversely affected by the above provisions of H.R. 8363 as presently drawn. The Royal-Globe organization is typical of the type of group adversely affected. The parent corporation of this group is the Royal Insurance Co., Ltd., a British corporation. Operations of the group are conducted in the United States in two forms: (1) Through British corporations which are qualified to do business in the United States; and (2) through U.S. corporations which are subsidiaries of the British corporations. This structure is dictated by the extremely valuable goodwill inherent in the name of each of the old-line companies. Each branch of a foreign company and each domestic company has its own agents countrywide and thereby competes actively, not only with other groups of insurance companies, but also with other members of its own group.

Each domestic insurer and each U.S. branch of a foreign insurer is a separate U.S. taxpayer. The domestic insurers file U.S. returns and pay tax on their income derived from all sources. The branches of foreign insurers file U.S. returns and pay tax at full corporate rates on all their income derived from U.S. sources. Each corporation, under current law, is entitled to its own surtax exemption.

These groups are not presently eligible to file a consolidated income tax return, because the statute provides that a foreign corporation is not an includible corporation for this purpose. Nevertheless, these groups will be denied multiple surtax exemptions under the bill (or forced to pay the alternative penalty), since foreign corporations are includible in a controlled group for this purpose. The report of the House Ways and Means Committee notes this discrepancy in definitions and states, at page 118:

"Your committee did not attempt to achieve complete symmetry between the definition of a controlled group of corporations for purposes of the foregoing multiple-surtax exemptions and the definition of a group eligible to file a consolidated return."

The report then notes that this decision may require review by stating:

"Moreover, your committee is not aware of any situations in which the discrepancies in the two definitions would create a hardship. If it develops, however, that the differing definitions create a substantial hardship for certain groups subject to the penalty tax which cannot file consolidated returns, the decision would have to be reconsidered and adjustments made to the extent possible."

While we were afforded an opportunity to discuss our problem with the staff of the Ways and Means Committee, it was not possible to gain an appearance before that committee, since the provision in question was inserted in that committee's bill only after its public hearings were closed. We assume the above-quoted comments in that committee's report were prompted, at least in part, by their recognition of the absence of opportunity for them to hear of such resulting inequities.

These groups of fire and casualty insurance companies are directly within the category with which the Ways and Means Committee was concerned. They are subjected to the penalty tax and yet cannot file consolidated returns. Thus, they are unable to offset the disadvantage of the penalty against the benefits of a consolidated return, such as freedom from taxation of intercorporate dividends and other intercorporate transactions and the current offset of profits and losses among companies. Conversely, the wholly domestic competitors of these groups will, after repeal of the 2-percent penalty tax, be able to enjoy these benefits of a consolidated return at no extra tax cost.

This does not accord equal tax treatment of the foreign affiliated groups with domestic affiliated groups and would therefore violate the obligation of the United States under its tax treaties with other nations. Article XXI of the income tax treaty between the United States and the United Kingdom provides, in effect, that British corporations shall not be subjected in the United States to "other or more burdensome taxes" than those which are imposed upon United States corporations.

The manifest inequity of tax treatment will be heightened by the imposition on these groups of a penalty for failure to file a consolidated return, whereas their domestic competitors will not be required to pay any penalty for so filing. Clearly, the resulting taxes imposed on the foreign corporations will be "more burdensome" than those imposed upon their domestic counterparts.

To cure the obvious defect in the bill, we respectfully recommend that section 1504 be amended as follows:

"Section 1504 of the Internal Revenue Code shall be amended by striking the period at the end of paragraph (b)(3) thereof and adding thereto the following: 'Other than foreign insurance corporations subject to taxation under section 831.'"

This proposed amendment would permit affiliated groups of fire and casualty insurance companies to file a consolidated return even though one or more of the companies joining in that return is a foreign insurance corporation, provided it and all other companies so joining in the return are qualified to do business in the United States and thus taxable under section 831 of the code.

The income to be reported on the consolidated return would be the same income that is presently reported to the United States on separate returns and

subjected to income taxation at full corporate tax rates. Thus, all of the income of the domestic members of the group would be reported. All U.S.-source income of the foreign companies engaged in business in the United States would be included, as this is the only income which is presently subjected to tax on their separate returns.

The concept is quite simple—these groups now have income subject to U.S. taxation. We propose merely that this same income be reported on a single rather than multiple returns. The express purpose of the proposed restrictions on surtax exemptions and the elimination of the 2-percent penalty is to encourage the filing of consolidated returns and to discourage the proliferation of corporate entities for tax purposes. Our proposal accords with that purpose.

Our representatives have consulted both with officials of the Treasury Department and with the staff of the joint committee on the technical aspects of this matter.

Thank you for the opportunity to present our position.

The CHAIRMAN. Thank you very much, Mr. Johnson. Thank you, sir.

I wish to place in the record a letter from A. Churchill Young, Jr., president of E. M. Todd Co., Inc., of Richmond, Va.

(The letter referred to follows:)

E. M. TODD CO., INC.,
Richmond, Va., September 18, 1963.

Senator HARRY F. BYRD,
Senate Office Building, Washington, D.C.

DEAR SENATOR: I am writing to you with reference to sections 222 and 223, surtax exemptions and consolidated returns, of H.R. 8363, revenue bill of 1963.

It seems to me that if these sections are incorporated in the new tax bill, it will do an injustice to concerns such as ours that have been separate corporations for many years—in our case, since 1927. At that time, as you know, the income tax was not a matter of too great concern to business corporations, and there was no thought of reducing taxes. You know that for years the Government has charged an extra 2 percent if a consolidated return was filed.

Back at the time the excess profits tax expired, the Government gave corporations the opportunity to file separate corporate returns if they so desired, and we, like many others, changed to individual returns at that time.

I hope you will agree with me on this matter, as it seems to me it puts a hardship on small concerns such as ours. Actually, the only saving is 22 percent on the first $25,000, or roughly $5,500 for each corporation, and such a sum is insignificant to large concerns.

As you know, I always enjoy having the pleasure of writing to you, and continue to thank you for what you have done for our State.

I take this opportunity to tell you how sorry I am that you cannot arrange to be at the dedication of the new laboratory at the Virginia Institute for Scientific Research on October 3. I happen to be a director and treasurer of the institute, and all of us were hoping that you could be present.

I trust I will have the opportunity to see you the next time you come to Richmond.

With kindest personal regards.

Sincerely,

A. CHURCHILL YOUNG, Jr., *President.*

The CHAIRMAN. Our next witness is Mr. Dudley Swim, of Carmel, Calif.

Please proceed, Mr. Swim.

STATEMENT OF DUDLEY SWIM, CARMEL, CALIF.

Mr. SWIM. Mr. Chairman and other gentlemen of the committee, thank you for this opportunity to appear before you. It is especially an honor to appear before any committee headed by our great American—your chairman, Senator Harry F. Byrd.

My name is Dudley Swim, Druid Hills Ranch, Route 2, Box 5000, Carmel Valley Road, Carmel, Calif. Occupation: Rancher and other business interests.

My remarks will be made in the following parts:

I. Philosophy.
II. Interest equalization tax (related to this bill).
III. Capital gains tax.
IV. Stock options.
V. Dividend credits.

PHILOSOPHY

The expressed intent of this bill, that is, to relieve the tax strangulation of our economy, is to be commended and strongly supported. Let's see that it does, in fact, just that.

The stimulation of tax reform cannot come too soon now. Some early signs of a possible later faltering or weakening in our economy are already appearing.

Painfully obvious is the irrationality of trying to operate a free enterprise system under a Marxian income tax system.

The so-called ability to pay principle is derived from the cliche "from each according to his abilities; to each according to his needs" enunciated by none other than Karl Marx. No more cunningly sugar-coated fraud was ever perpetrated on a gullible mankind. Yet, this Marxism underlies our income tax system.

Witness the contrasting spectacular growth in that small area which is under our flag but not under our confiscatory income tax system. I refer to Puerto Rico. To return from the flourishing, vigorous economy of Puerto Rico, with its cheerful, eagerly progressing people, to the relative stagnation and discouragement in the United States, is comparable in degree to the psychological experience of passing from West Germany into East Germany.

Not only is our graduated income tax repressive and brutal in its Marxian extreme, but its attitude invites sadism in its administration. The spirit of creativity and productivity is penalized as though it were sinful.

Without waiting for the incentive effect of tax reduction to take place, a notable improvement can be accomplished in our budget by applying the simple administrative principle—but politically unpalatable course—of pruning the payroll. There is hardly a large organization in the United States today—private or governmental—where reduction in payroll by trimming out the least competent 10 percent would not step up the overall effectiveness.

Tremendous savings can be accomplished in ceasing our great international boondoggle known as foreign aid * * * even though it is the bureaucrat's delight.

Instead of these fantastic giveaways that have lost us respect the world around, and have made no friends, why not proceed internationally on the old RFC (Reconstruction Finance Corporation) principle which paid out so handsomely in the 1930's without a nickel in final cost to the taxpayer.

In each country we desire to aid, a development association could be set up jointly with the foreign government concerned.

For example, the Indo-American development association could be formed as a joint creation of the Indian and American Governments to dispense credits and technical assistance to private enterprise in India. The credits would be on a liberal, long-term basis and designed to be self-liquidating ultimately. If local enterprise should not be up to a given task, a joint venture with, or participation by, American private enterprise could be encouraged or arranged. This would materially assist in the know-how.

World development and especially the better feeding and clothing of the people in undeveloped areas must depend ultimately on individual creativity and productivity, i.e., our task is to help people help themselves. So the sooner we drop the pursuit of the socialist mirage in our foreign aid and the sooner we get onto a basis of individual responsibility, the sooner will come the much sought improvement in human living standards.

Here we are in the midst of one of the greatest revolutions of all times—the fabulous revolution in the production of foodstuffs brought about by the brilliance of American agricultural science and the enterprise of the American farmer—proudly that bulwark of American individualism.

The American farmer produces an overabundance. The American farmer can—between his production and the teaching in other countries of this very skill in production—feed the world and win the cold war hands down. The Socialists have struck out in the farming "ball game" and are now on their knees begging for help from private enterprise.

If our State Department would run interference against foreign political barriers, companies such as California Packing Corp., with its skill and know-how in the production, preservation, and marketing of foodstuffs, could step into almost any underdeveloped country and through joint private initiative trigger the rapid conquest of undernourishment.

Remember, America—despite the competitive handicap of high land cost, of the highest wages and the highest tax burden anywhere in the world—can still produce, process and distribute to the consumer foodstuffs generally at a cost equal to, or less than, and certainly in more abundance, than any other country in the world.

This is our great secret weapon in the cold war, and we can share it with our friends abroad to counter the strangulation and poverty of socialism.

INTEREST EQUALIZATION TAX

In the first place, the title is palpably misleading. The purpose of this provision is admittedly to embargo the export of capital for investment purposes. It would be a tragic letdown to private enterprise in those friendly countries who depend on our capital markets.

After building toward the goal throughout this century, we have succeeded in making America the investment capital of the world. It means so much for American leadership and influence. American business and American capital have been winning the cold war while our bureaucracy has been losing it. Let's not wreck these achievements by this trick tax and a continuation of discriminatory taxes on foreign subsidiaries of American companies.

To balance its foreign exchange position any country with a decent credit standing can borrow in world money markets to correct the exchange imbalance. Why should our Treasury be so reluctant to use a normal, traditional method and instead propose a crippling tax on our world capital leadership that would be a step back toward isolation.

The excuse given for our Government's not doing more foreign borrowing is that the Treasury is opposed to creating a preferred class of creditors abroad in its borrowing operations. If we assume maintenance of the present gold value of the dollar, how would a foreign creditor, say in Swiss francs, enjoy any preference over a domestic creditor in dollars? Borrowing in foreign currencies in some capital markets abroad might involve slightly higher interest rates but this would be a small price to pay for maintaining America unfettered as the world center for private capital.

Moreover, our Government and foreign governments should realize that, in part, American business has grown out of a national status into a world status. Many of our leading companies are serving customers worldwide, utilizing raw materials from many areas of the world, producing in many other countries, and in fact becoming owned in part internationally. This is vitally contributing toward a robust, interdependent free world economy with business becoming internationalized on a private ownership basis.

Instead of this miserable tax proposal, all that need be done is to create here an atmosphere attractive to capital. Witness the example of Switzerland with its heavy inflow of capital.

CAPITAL GAINS TAX

There are other advanced countries that impose no tax whatsoever on capital gains. Might it not pay with respect to the international balance of payments for the United States to be competitive on this score?

Domestically, our objective is to free up the economy. Much capital is frozen in under our present capital gains rates.

Let's repeal the tax altogether or at least reduce it to an unequivocal 10 percent on longer term capital gains; that is, capital assets held for 3 or 4 years and longer. The present capital gains provisions could be retained for the intermediate term capital gains—that is those held for more than 6 months but less than the period to qualify as longer term capital gains.

STOCK OPTIONS

Special tax provisions for management options were born out of the confiscatory income tax rates inaugurated in the 1930's.

Now, if fair and reasonable individual income tax rates are restored, the occasion which gave rise to this dubious loophole disappears. There is no reason why corporate management should constitute an especially privileged group.

Stock options have become dangerous. When abused—as they have been in various cases—they become the modern form of dipping the hand into the corporate treasury.

Note the insolence of requests by numerous managements for lowering the exercise price of the options and for extending the period long after the option deal has been made and has not worked out to the profit of the management; also the hit-and-run sellouts by management optionees only to come back after a brief period to seek still another tax avoidance handout.

If those in management are not willing to become riskbearing stockholders, the same as stockholders at large, and therefore are not willing to bet on their own ability, why should stockholders repose the confidence in a management that such management is unwilling to place in itself? Likewise, why should the Government grant tax subsidy to such practices?

Those in management seeking the riskless free ride of an option, plus the donation of inflation, should realize that they are compromising our free enterprise ssytem where profit is a reward for the assumption of risk.

Stockownership by management is highly desirable. There is nothing by way of legitimate incentive that cannot be accomplished by a stockownership plan based on current purchases of stock by management for long-term holding. The regular capital gains provisions would then automatically apply and without any special legislation discriminating in favor of a small group.

DIVIDEND CREDIT

In the 1954 act, a small step toward reform to eliminate double taxation on corporate earnings was inaugurated.

To subject corporate earnings to two layers of exhorbitant tax rates is utterly indefensible.

In countries where savagery is not practiced on earnings, the economics of corporate earnings are clearly recognized. With respect to the earnings distributed as dividends, the stockholder receives the credit on his individual income tax return for the corporate taxes already paid on these earnings.

It is vital that this reform, started in 1954 in a very small way, be continued and not abandoned. Our goal should be a full recognition of the taxes already paid by the corporation. Accordingly, let's increase, not decrease, the dividend credit—both in fairness and to attract capital to the United States.

Now in our beloved America let's stop stepping on our own feet. Man is so inclined to create his own troubles. Let's stop strangling free enterprise with Socialist tax tricks and sadistic devices.

Why not unleash our potential dynamics with a simple, honorable, straightforward tax system that does not prejudice creativity and productivity.

We need not continue to be like the "wild whoofenpoffer" that flies backward to keep the wind out of its eyes.

The CHAIRMAN. Thank you, Mr. Swim.

Any questions?

The committee will recess until 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

WASHINGTON, D.C., *November 15, 1963.*

Re H.R. 8363, section 221, income averaging.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: If your committee should approve the income-averaging provisions of section 221, we would like to urge that the bill, as reported by your committee, retain the proviso which would afford certain taxpayers the right to elect, with respect to any particular year, the relief provisions of present sections 1301 and 1307. This proviso is absolutely necessary to preclude a hard result as to those taxpayers who have been relying on the present law for a number of years.

As originally proposed, the new income-averaging provisions would afford taxpayers relief only if their current year's income exceeded by 133⅓ percent the average of the taxpayer's income for the previous 4 years. It was designed to take care of hardship situations experienced by entertainers, authors, athletes, artists, and other professionals whose incomes tend to fluctuate greatly. However, as originally proposed, the bill would have denied the full relief afforded by the present law to certain taxpayers who had been working on professional employments for periods long in excess of the 5-year period involved in the proposed income-averaging provision. This would be grossly unfair as those persons had entered into those employments in good faith, relying on the provisions of present law which provide relief from the impact of graduated rates on bunched income by computation of tax with respect to the entire period in which the services were rendered (not merely the last 5 years). Such unfairness was not intended by the draftsmen of the original legislation, we are sure.

To avoid the inequity, the House committee added a proviso which would allow taxpayers, who had entered into long-term employments prior to February 6, 1963, to elect to apply the existing law instead of the new income-averaging provisions. This would enable the taxpayer to compute the tax on long-term employment income as if received ratably over the period of the services. In cases of certain taxpayers who have been rendering such services over periods of 15 to 20 years, under contingent or deferred-payment contracts; for example, the House approach would be more equitable and would take into consideration the practical fact that in most instances employments under such circumstances result in little or no income in the earlier years; for true tax equity the income should be related to those years, not merely the last 5 years in which the taxpayer might have other income and realize little relief.

We would appreciate your including this letter in the record of your proceedings. In the event the income-averaging provision is adopted by your committee, we strongly urge your committee to retain the protective proviso inserted by the House with respect to employments prior to February 6, 1963.

If there are any questions on this matter, we shall be pleased to discuss them with you or your staff.

Sincerely yours,

WILKINSON, CRAGUN & BARKER,
By ROBERT W. BARKER.

STATEMENT IN BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION BY DAVID FLOWER, CHAIRMAN, TAX COMMITTEE

This statement is submitted in behalf of the Electronic Industries Association and its tax committee. The Electronic Industries Association (hereafter referred to as EIA), is the national organization representing approximately 300 manufacturers of electronic products and components. Its members have plants in all of the 50 States and in many foreign countries.

We support immediate passage of H.R. 8363 without restricting limitations. At the same time we strongly support the principles stated in section 1, recognizing the need to restrain Government spending. If, as now appears likely, the bill is not enacted in 1963, we urge early action and further urge that the effective date for tax rate reduction be made retroactive to January 1, 1964. We feel

that rate reduction is a most needed tax reform. We also view it as an important and necessary step to stimulate and to alleviate the retarding of the Nation's economy. In the words of President Johnson, "This is a bill designed to increase our national income and Federal revenue and to provide insurance against recession."

As indicated above we urge early enactment of H.R. 8363. However we urge that consideration be given to the following recommendations on the subjects of restricted stock options, group term insurance, depreciation, the investment incentive credit, moving expense, and rates.

1. *Restricted stock options.*—Restricted stock options, as provided by section 421 of the Internal Revenue Code of 1954, are effective means for providing key employees with incentives to make a maximum contribution to the long-range growth of the business. Long-range growth is one of the key elements required in the furtherance of truly meaningful stockholder, company and national goals. EIA believes that it is essential to retain in our tax structure the established treatment for restricted stock options in order that the motivation for management to take the long-range approach be maintained.

Because of the foregoing, EIA objects most strongly to the provision in H.R. 8363 which would reduce the permissible period for an option to be outstanding from the present 10 years to 5 years. With the shorter period, the employee's opportunity to benefit from increased profitability and increased market value of the stock is limited and will serve to restrict the long-range view and long-range growth.

EIA also recommends that the effective date of any new provisions applying to restricted stock options be made to coincide with the enactment of the bill. Since these provisions do not have a significant effect on the revenue and recognizing the need in such a sensitive area for a smooth transition to the new rules, we believe that adoption of this effective date would be most appropriate.

2. *Group term life insurance purchased for employees.*—Section 203 of H.R. 8363 provides that the cost of group term life insurance provided an employee by his employer shall be included in the gross income of the employee to the extent that such cost exceeds the cost of $30,000 of protection.

The language in the bill provides for a determination of cost either by using a uniform table of premiums computed on the basis of 5-year age brackets, or by using the actual cost of the insurance protection where such cost is computed on the basis of the individual ages of the employees or on the basis of similar 5-year age brackets. Both of these methods, in their emphasis on the age of employees, fail to take into account the underlying theory of group life insurance. In addition, both methods would present difficult administrative problems.

H.R. 8363 should be amended so as to permit the computation of the costs of group term life insurance by the single average premium method; i.e., by the use of a level premium based on the employer's cost for overall group term life insurance. The use of this method would avoid problems of administration which would result in added expense and difficulty caused corporate taxpayers, and ultimately in reduced revenue as the result of increased administrative costs. Such additional procedures as determination by the employer's payroll office of the age of each participating employee, the establishment of a continuing record of employees' contributions, maintenance of records reflecting the length of service of each employee, and the computations involved in determining which of the two permitted methods might be more advantageous to the employees, would result in a significant increase in the costs of administering group term insurance plans.

In addition, EIA feels that the methods of determining cost now provided in the bill disregard the fundamental concept of group life insurance, a concept which comprehends an amalgamation of employees of various ages into a single group and the payment of an average level premium for that group.

It is the strong suggestion, then, of EIA that section 203 be amended to provide that the cost of group-term life insurance shall be determined on the basis of the average premium cost per each thousand dollars of coverage provided all employees during the taxable year.

3. *Depreciation.*—S. 2231 introduced by Senator Hartke would codify guideline depreciable lives and, more importantly, remove the complicated reserve ratio test.

The codification of lives would provide with greater assurance as to the permanency of these lives. As matters now stand, guideline lives could be changed at any time at the whim of the Treasury Department.

The reserve ratio test is a limitation on the guideline whereby the benefit of the guideline would be diminished or lost entirely if at periodic intervals the taxpayer's experience did not square with certain mathematical ratios and computations so complex as to defy comprehension by anyone other than a depreciation expert.

Removal of the reserve ratio test would greatly simplify the administration of depreciation and enhance the beneficial effect of the guidelines on our economy.

4. *Investment incentive credit.*—We wholeheartedly support the improvement in the investment credit whereby last year's amendment reducing the basis of the property for depreciation by the amount of the credit would be repealed. We have had discussions with the Treasury Department on this and know that it was the intention of the draftsman that this repeal have the further effect of eliminating a problem which existed for Government contractors. This problem arose from the fact that the Government procurement regulations provide that recovery of the cost of capital items is to be made in the form of depreciation, and the depreciation is to be the same as that provided in the Internal Revenue Code. The provision in the bill restoring the full basis for depreciation solves this contract cost recovery problem.

There is, however, some slight possibility as the result of the further change in the investment credit with respect to the timing of the "flow through" of benefits to regulated public utilities that under a rule of statutory construction there might be an interpretation that there should be no "flow through" of benefit to Government contractors and that the restoring of the full basis for depreciation might be disregarded for cost recovery purposes on Government contracts. To obviate this recognizedly remote possibility, it is suggested that a statement of congressional intent be added in the Finance Committee report to the effect that the restored basis for depreciation should have the effect of providing full cost recovery to Government contractors without regard to tax benefits they have from the investment credit.

5. *Moving expenses of employees.*—EIA endorses in principle the provisions and objectives of section 212 of the House bill under which a deduction is provided for moving expenses incurred by new employees and by unreimbursed old employees. We believe that the provisions will mitigate the problem of structural unemployment by eliminating significantly the income tax discrimination presently existing between old employees who are reimbursed and those employees provided for by this amendment.

However, the House bill does not provide relief for employees with respect to a number of ordinary and necessary living and transportation expenses reasonably related to the move and due to reassignment or acceptance of employment at a new job location. These expenses, the Treasury holds, are personal expenses and yet it is inconceivable that an employee can consummate a transfer without incurring substantial ordinary and necessary living and transportation expenses reasonably related to the move, generally at the request of the employer. The reimbursement of these expenses affords no economic benefit to the employee and merely makes him whole. Employees of members of the electronics industry would especially welcome tax relief in this area because of the instability of employment in the industry.

6. *Rates.*—We would not want our comments on rate reduction to interfere in any way with the enactment of the bill. In the event, however, that the Finance Committee does undertake a reconsideration of the rates, we make the following comments.

We believe more substantial and prolonged economic growth can be achieved through substantial rate reductions which would encourage personal initiative and make available funds for new capital and investment. This position seems consistent with the administration's recommendation of an unlimited carryover of capital losses that would, in the words of former President Kennedy, "improve the investment odds, encourage risk-taking on the part of investors and stimulate economic growth." We believe that tax rate reform should be based upon an equitable reduction in all of the present steeply graduated rates, with resulting greater reduction in the middle-income brackets than is provided in the bill. An

equitable reduction would accelerate the requisite new business investment necessary to create jobs and the income required to reduce the budget deficit while, at the same time, provide sufficient stimulus to increase consumer spending.

FRAZER & TORBET,
Milwaukee, Wis., November 29, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. BYRD: We request reconsideration of proposed code sections 421–425 re qualified stock options as they appear in H.R. 8363, Revenue Act of 1963. We believe that the proposed change in restrictions on attributable ownership work a hardship on medium-sized corporations and result in a peculiar inequity where brothers are employed by a single company. These code sections would disqualify all brothers where their aggregate, attributable ownership in a medium-sized company exceeds 5 percent. In usual circumstances this would work to disqualify brothers from participation in qualified stock option plans where their individual ownership holdings were as small as 2 to 3 percent. In extreme cases one brother who (together with his spouse, ancestors, lineal descendants, and other business interests) owned absolutely no shares would be disqualified from participation if the aggregate attributable ownership of his brothers exceeded 5 percent.

As now written the proposed change in restrictions on attributable ownership from 10 to 5 percent would seem to affect only the option plans of medium-sized corporations. In the smaller companies ownership is usually so concentrated that a change from 10 to 5 percent would have little if any effect. For the larger companies the tremendous amounts of invested capital result in very wide dispersion of ownership so that even a 5-percent ownership restriction is indeed liberal. In the very largest corporations the proposed change from 10 to 5 percent would probably not affect even the wealthiest families in the United States. When applied to medium-size companies, however, the change is significant and material. Where a single executive is involved his ownership in a $2 million company could not exceed $100,000. But when only two brothers are involved individual ownership would be restricted to less than $50,000 after receipt of the options. Many of the medium-size corporations of today have sprung from family businesses and will be affected by the proposed changes.

We know of one corporation which presently employs two brothers as full-time executives. This is the Godfrey Co., of Milwaukee, Wis., a wholesaler and distributor of foods. The company was founded some 90 years ago as a wholly owned enterprise of the brothers' grandfather. The brothers have been employed by the company throughout their business careers and have been instrumental in the growth of a company which now employs over 890 persons. Through the years, the company has shown substantial growth and now has capital of $4½ million, accumulated through family investment, public offering of the shares, and retained earnings. At the time of public stock offering all shares were sold by the company itself; none were sold by the brothers as existing shareholders. Subsequent to the public offering which was in 1959, one brother made no sales of stock, and the other, over the 5-year period, has sold net only 732 shares, and 500 of these were to an outside investment fund which wanted to invest in Godfrey Co. stock and could not acquire that many in the public market. This sale was for the purpose of widening distribution of the Godfrey Co. shares and thus be helpful in future stock sales, as additional funds are needed in connection with the company's expansion program.

As a result of the public offering and the inheritance process ownership has become substantially dispersed so that individually each brother owns less than 5 percent of the company. As key executives, it would be expected that the brothers would participate in any qualified stock option plan the shareholders might adopt. However, the proposed 5-percent restriction on attributable ownership of shares, to include holdings of brothers, would disqualify them from participation.

The approximate current ownership positions of these brother executives are as follows:

	James and wife		John and wife		Combined	
	Shares	Percent	Shares	Percent	Shares	Percent
Record and beneficial	8,949	2.58	12,136	3.50	21,085	6.07
Lineal descendants, ancestors, in common	218	.07			218	.07
Subtotal	9,167	2.65	12,136	3.50	21,303	6.14
Sisters					13,226	3.81
Total	9,167	2.65	12,136	3.50	34,529	9.95

NOTE.—Total shares outstanding 347,162 (100 percent).

It is important to note that both brothers meet the requirements of present law and do qualify for restrictive stock options. Further, both brothers could qualify under the proposed 5-percent limitation if their holdings were considered individually. However, under the proposed 5-percent limitation coupled with the proposed rules of attribution neither brother would qualify.

The ownership of each brother is modest when measured by either percentage or dollar amount. In the aggregate their holdings do not afford control and individually their percentage ownership is of course reduced. Certainly, executives of larger companies having much greater individual investments in their companies' ownership will retain their right to participate in stock option plans while these brothers with more modest investments would be disqualified under the proposed change in ownership restrictions.

We would propose that if the ownership restrictions are changed from 10 to 5 percent that holdings of brothers and sisters be excepted from the rules of attribution. The parallel position of brothers and sisters as distinguished from the vertical position of ancestors and lineal descendants has already been recognized in code sections re transfers between related persons. Code section 1235 (d), for example, specifically excludes brothers and sisters from the definition of related persons when determining if the sale of patents results in capital gain or ordinary income. We believe that code sections 421–425 should also provide for exclusion of ownership interests of brothers and sisters in determining whether an individual's stockownership complies with the proposed 5-percent limitation for purposes of qualified stock option plans.

We thank you for your considerations in this matter. A letter containing this same information has also been delivered to Robert H. Elliott, Jr., Office of the Tax Legislative Counsel, U.S. Treasury Department, Washington, D.C.

Very truly yours,

JOHN P. CHOLE.

STATEMENT BY SIDNEY Z. MENSH, PRESIDENT, ASSOCIATION OF REALTY INVESTMENT CORPORATIONS, INC., WITH RESPECT TO H.R. 8363, THE REVENUE ACT OF 1963

Mr. Chairman and members of the committee, on behalf of the Association of Realty Investment Corporations, I wish to submit the following comments of the association on H.R. 8363.

Our association is an association of corporations engaged in the business of purchasing and holding real estate for investment. We are submitting comments only on those aspects of the bill which directly affect the activities of the members of our association.

I. SECTION 220. GAINS FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

Section 220 provides that where depreciable realty is disposed of recognized gain is taxable at ordinary income rates to the following extent:

(a) If the disposition is within the first year following acquisition or completion of construction, all of the gain is so taxable to the extent of depreciation adjustments in respect of such property.

(b) If the disposition occurs more than 1 year after acquisition or completion of construction but less than 10 years thereafter, gain is taxable as ordinary

income to the extent of the excess of depreciation adjustments over the depreciation adjustments which would have resulted if such adjustments had been determined under the straight line method of adjustment; however, this "excess" depreciation is so taxable only in an amount determined by multiplying such excess depreciation by the "applicable percentage" which is 100 percent for the first 9 months of the 2d year and which reduces 1 percentage point a month beginning in the 10th month of the 2d year.

(c) If the disposition is more than 10 years after acquisition or completion of construction, then this provision does not affect the character of the gain. Thus, a taxpayer holding property as to which accelerated depreciation has been used will not receive complete capital gain treatment until after the property had been held for more than 10 years.

This provision was inserted in H.R. 8363 upon the representation of the Treasury Department that there was an area of abuse arising from the use of accelerated depreciation methods (which produces a deduction against ordinary income) coupled with early disposition of the property (producing long-term capital gain under existing law). The Treasury Department in its presentation to the House Ways and Means Committee cited a number of examples where accelerated depreciation was used to obtain ordinary deductions followed by a sale within a very short period (usually less than 3 years) resulting in long-term capital gain.

Our association agrees that the combination of (1) accelerated depreciation plus (2) quick turnover of real property results in tax benefits under present law which should not be allowed. However, we believe that the approach taken by the House of Representatives goes too far when a taxpayer is required to hold the property for more than 10 years in order to avoid the penalty provided by section 220. A provision explicitly inserted as a penalty designed to strike at the quick turnover of real estate which has been subjected to accelerated depreciation should not be so extended as to penalize the normal investor in real estate who holds the property for several years before disposition.

In the capital gain-ordinary income area a number of tax avoidance devices have been devised as to which the Congress has seen fit to provide a statutory penalty. For example, the use of so-called collapsible corporations led to the enactment of what is now section 341 of the 1954 code. The collapsible corporation was a device whereby a taxpayer converted what would have been ordinary income to the corporation into long-term capital gain to the shareholder. The congressional remedy is a provision which taxes gain in respect of the stock of a collapsible corporation as gain from the sale or exchange of property which is not a capital asset. The Congress agreed, in two different parts of section 341, that after a certain period of time has elapsed the loophole that Congress sought to close is no longer present. Both in the definition of what constitutes section 341 assets (section 341(b)(3)) and in a general limitation on the application of section 341 (section 341(d)), the statute provides that after a holding period of 3 years the relevant provision of the statute does not apply. This constitutes a recognition by the Congress that in the context of section 341, gain derived over a period of less than 3 years should be taxable at ordinary income rates but gain derived over a period of more than 3 years was properly taxable at long-term capital gain rates, even though the statutory provisions would otherwise have applied.

A similar problem was faced, in a different context, in the real estate investment trust provisions, sections 856–858, which were added in 1960. The basic concept is to provide for a single income tax, at the shareholder level, for a real estate investment trust which meets the various requirements of the statute. Incidentally, the members of our association, all of which are corporations, are not eligible for the beneficial tax treatment provided for by the real estate investment trust provisions. We believe this discriminates against corporations, is inequitable and should be changed to allow corporations to qualify under section 856.

One of the restrictions of section 856 is that less than 30 percent of the gross income of the real estate investment trust may be derived from the disposition of real property held for less than 4 years. Thus, where the collapsible corporation provision draws the line at a 3-year-holding period the real estate investment trust provisions draws the line at a 4-year-holding period.

We respectfully suggest that the provisions of section 220, which draw the line at a 10-year-holding period, are extreme and unnecessary. A shorter holding

period than 10 years would prevent the abuses alleged to exist, where accelerated depreciation is combined with quick turnover of real estate.

We have noted that the real estate investment trust provisions contain a 4-year-holding period. In order not to increase the existing discrimination between real estate investment trusts and realty investment corporation we propose that the formula set forth in section 220 be revised so that after a holding period of a full 4 years, gain on the disposition of depreciable real property is not subject to section 220 and is entirely long-term capital gain. In order to achieve that result we request that section 220 be amended so that beginning with the 17th month of holding period the percentage of gain taxable at ordinary income rates is reduced 3 percent per month in lieu of 1 percent per month, with the gain in the 5th year not affected by the provision.

II. SECTION 216. PERSONAL HOLDING COMPANIES

Section 216 substantially changes the present rules for personal holding companies.

The bill operates to penalize corporations actively engaged in the real estate business. For many years, if rents constituted more than 50 percent of a corporation's gross income, they were excluded from personal holding company income.

Under the bill, a net rent concept is introduced in ascertaining whether rentals constitute 50 percent of gross income. By requiring the subtraction of depreciation and taxes in such computation the bill can create the result that an active real estate corporation becomes a personal holding company, totally from fortuitous circumstance, for example, a temporary and unexpected drop in rental income which causes the magic formula to apply.

Furthermore, under the bill, all rents will be personal company income if passive income (e.g., dividends, interest) is more than 10 percent of total income. If, for example, an active real estate corporation sets aside funds for future maintenance or improvement, the corporation will be a personal holding company if the income from such funds exceeds 10 percent of the total income.

We believe that in these two respects the personal holding company provisions go far beyond what is needed.

STATEMENT OF CLAY PIPE INDUSTRY DEPLETION COMMITTEE, WASHINGTON, D.C., SUBMITTED BY CLARK SUTHERLAND, CHAIRMAN OF DEPLETION COMMITTEE

FOREWORD

The purpose of this paper is to make known to legislators in Washington and others the position of the vitrified clay sewer pipe industry with respect to percentage depletion allowances for clays used in the manufacture of its products.

First, a word about the industry. It is small when compared with other basic industries, but very important in its contribution to the physical well-being of the American people by providing sanitation through long life sewage facilities. Many cities and States, including the Nation's Capital, Washington, D.C., specify or recommend clay pipe for all sanitary sewerage systems in product sizes manufactured by the industry. In short, it is an essential, highly specialized, but low profit industry.

There are approximately 80 plants in the United States manufacturing vitrified clay pipe with a potential capacity of 2.5 million tons annually. The plants are located in areas where selected raw clays needed in the manufacture of its products can be found.

It is the position of this industry that the laws governing percentage allowances for Federal income tax purposes are discriminatory when compared with allowances granted to certain other nonmetallic industries. In all equity we assert that—

(1) The percentage depletion rate for sewer pipe clays should not be less than the allowance for other clays or for limestone used in the manufacture of cement.

(2) The method of computing the allowance for clays used in the manufacture of clay pipe is unfair when compared with the method allowed for

limestone used in the manufacture of cement, a product used in the manufacture of a competitive product, concrete pipe.

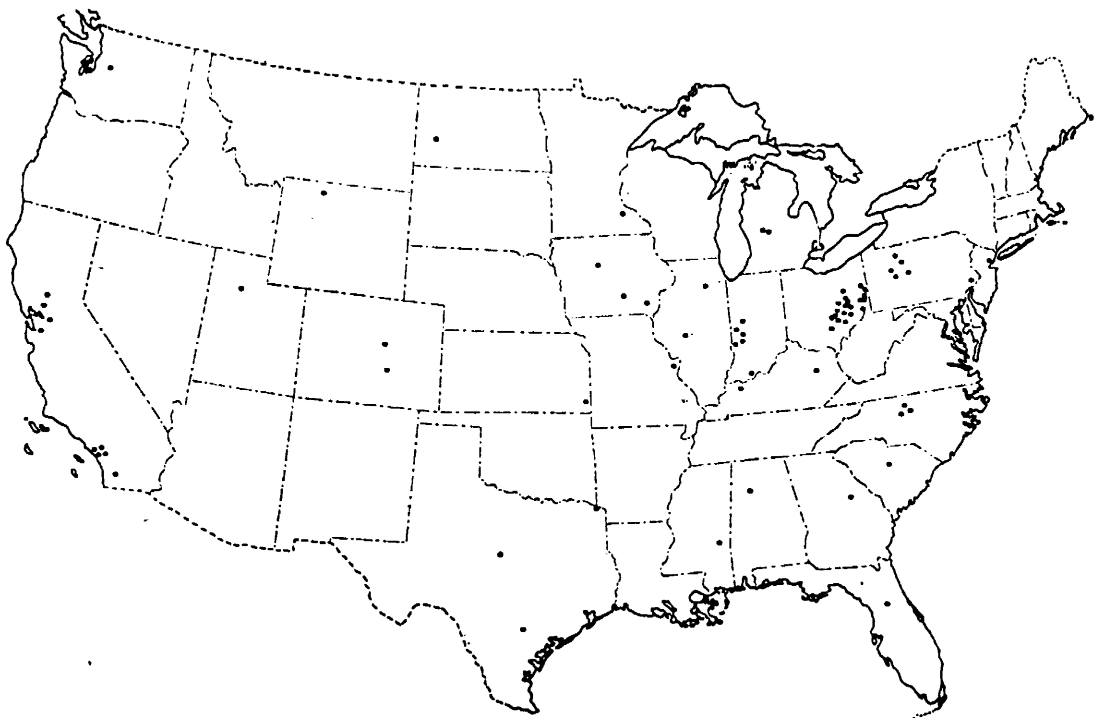
Under the existing Federal tax statutes many nonmetallic minerals including clay (when sold or used for purposes dependent upon its refractory properties) are permitted a percentage depletion allowance of 15 percent. On the other hand clay used, or sold for use, in the manufacture of building or paving brick, drainage and roofing tile, sewer pipe, flowerpots, and kindred products is permitted an allowance of only 5 percent.

It is not the purpose of this paper to protest the higher rates allowed for any of the other minerals. We believe that the availability and the cost of recovery of natural resources usable by the miner-manufacturer should be the principal factor for the determination of the allowable rate.

Clays used in the manufacture of sewer pipe must have specific and controllable properties. This subject is covered in detail in an article included herewith (exhibit 2) entitled, "The Raw Material Situation in the Vitrified Clay Sewer Pipe Industry" by Dr. J. O. Everhart, chairman, Department of Ceramic Engineering of the Ohio State University.

Clays that are usable in the manufacture of sewer pipe, because of their scarcity, are entitled to a depletion rate equal to that allowed for any other type clay and certain other nonmetallic minerals, for example limestone (15 percent) used in the manufacture of cement. To illustrate our contention we have canvassed the manufacturers of sewer pipe as to the types of clay used in the mixture to produce pipe, the percentages of each type, the distance of deposits from the plants and the estimated reserves of clay. This data is tabulated on the following page for a number of the larger plants throughout the United States.

Location of plant and types of clay used	Percentages	Distance of deposits from plant (miles)	Estimated reserve (in years)
California:			
Fire clay, grade No. 1	25	55	15
Fire clay, grade No. 2	37½	55	10
Fire clay, grade No. 3	12½	55	12
Shale	25	55	4
Texas:			
Plastic shale	37½	5	10
Vitrifying shale	37½	100	3
Refractory clay	25	5	10
Mississippi:			
Refractory clay	12½	26	8
Refractory clay (low grade)	12½	13	17
Plastic shale	50	4	13
Weathered shale	25	150	19
Alabama:			
Refractory clay	28	32	6
Weathered shale	56	1	19
Unweathered shale	16	1	60
Kansas:			
Plastic shale	11	3	40
Refractory bond clay	22	6	10
Vitrifying shale	44½	10	12
Fire clay	22½	13	12
Pennsylvania:			
Refractory clay (bond clay)	35	18	10
Shale	40	1	20
Fireclay (low shrinkage)	10	200	10
Fire clay	15	80	6
Illinois:			
Shale	80	1	48
Fire clay	20	200	40
Ohio:			
Refractory clay (bond clay)	17	6	3
Fire clay	17	6	5
Fire clay	16	6	10
Shale	50	6	4
Georgia:			
Shale	88	170	15
Refractory clay	6	18	30
Oxide clay	6	18	10
Florida:			
Fire clay	40	450	50
Shale	60	450	50



Location of Vitrified Clay
Pipe Plants

Many companies in the industry employ geologists who are continuously engaged in exploration and testing for usable clays to extend reserves.

Vitrified clay sewer pipe must meet rigid engineering standards as required by the American Society for Testing Materials, and to meet these standards in the control of dimensions the product can be made only from heat resistant clays, generally a mixture of refractory clays and shales.

The Public Debt and Tax Rate Extension Act of 1960 provides for a 15-percent rate for clay only if it is used or sold for use for purposes dependent upon its refractory properties. In other words, if used to make firebrick the rate is 15 percent but if used in the manufacture of clay pipe the rate is 5 percent in spite of the fact that refractory clays are just as necessary in the latter product. The rates are therefore discriminatory. Under the prior law, refractory and fire clay used in the manufacture of clay pipe was allowed the 15-percent rate as evidenced by Revenue Ruling 56–59 which defined refractory and fire clay as clay used or sold for recognized refractory purposes except for the inclusion of the following sentence: "In this connection, fire clay used to enable sewer pipe to retain its shape and dimensions under extremely high temperatures required for vitrification is considered to be used as refractory fire clay." Public Law 87–312, the relief measure enacted in 1961 also provided for a 15-percent rate for refractory and fire clay regardless of end use. It is apparent that the sponsors of the existing law were uninformed regarding the need of refractory clays in the manufacture of vitrified clay sewer pipe. Without this essential component (heat resistant clays) the clay pipe industry could not exist.

Pipes used in sewage systems are made from clay, cement, cement-asbestos. fiber, certain metals and plastic. The principal competitor of clay pipe in this field is concrete pipe made from cement. Construction Review, February 1960 issue, on the basis of a 1957 survey reports production of 6,459,000 tons of concrete sewer pipe during that year from 424 plants scattered throughout the United States compared with production of 1,731,000 tons of clay pipe production from 71 plants located in 21 States.

Limestone used in the manufacture of cement from which concrete pipe is made is allowed a percentage depletion rate of 15 percent. We feel that the rate of 5 percent for clays used in the manufacture of clay pipe is discriminatory when compared with the cement industry for two reasons: (1) Known reserves of limestone usable in the manufacture of cement, in relation to usage, are much greater than known reserves of clay usable in the manufacture of clay pipe; and, (2) concrete sewer pipe in direct competition with clay pipe.

Under the Public Debt and Tax Rate Extension Act of 1960, the present law. treatment processes considered as mining in the use of calcium carbonates and other minerals, when used in making cement includes all processes (other than preheating of the kiln feed) supplied prior to the introduction of the kiln feed into the kiln. In the case of clay used in the manufacture of clay sewer pipe no processes beyond crushing and grinding the clay are considered as mining. Certain ordinary treatment processes allowed determine the "cutoff point" for computing the allowance, the more processes considered as mining the greater the depletion allowance under the "proportionate profit" method. In the manufacture of clay sewer pipe the "cutoff point" should be the same as for cement, namely the kiln feed. This point is graphically illustrated by exhibit 1 attached hereto.

(Exhibit 1 was a foldover illustration that could not be reproduced in hearings. Thus, it was made a part of the committee files.)

In light of the facts herein given it is exident that the existing statutes governing percentage depletion allowances are discriminatory and unfair to a small but basic industry both with respect to allowable rates and treatment processes considered as mining. We therefore urge the passage of corrective legislation.

EXHIBIT 2

THE RAW MATERIAL SITUATION IN THE VITRIFIED CLAY SEWER PIPE INDUSTRY

(By J. O. Everhart, chairman, Department of Ceramic Engineering, the Ohio State University)

Man has used vitrified clay sewer pipe for sanitation and drainage purposes almost from the beginning of civilization. The complexities of modern cities and industrial development have increased our dependence on vitrified clay

sewer pipe, and, at the same time, imposed increasingly severe requirements on their performance.

The primary function of vitrified clay sewer pipe is to transport domestic sewage and industrial waste from the point of origin to some place where it may be treated and disposed of. Vitrified clay sewer pipe must be resistant to the attack of acids, alkalies, solvents, and corrosive vapors generated by sewage and waste.

Because of the problems involved, users and manufacturers of vitrified clay sewer pipe have formed a specifications committee under the auspices of the American Society for Testing Materials. This committee has written complete specifications for establishing acceptable quality in vitrified clay sewer pipe. All vitrified clay sewer pipe installed in urban and in nearly all rural areas must meet either these specifications, or a local code based on them. These standards of quality impose severe limitations on the raw materials that may be used to manufacture an acceptable product.

Vitrified clay sewer pipe is a thin-walled product with a complicated socket on one end and is made in lengths up to 5 and 6 feet. Most vitrified clay sewer pipe made today is sold with a factory made compression joint attached. These joints expedite laying of the line and insure its watertight integrity. Their development has been a tremendous technical achievement, but it has also created problems. The use of these joints has required better size control in the pipe and again made selection of raw materials having more uniform performance absolutely necessary. Fire clay or refractory type material is an essential component material in the manufacture of vitrified clay sewer pipe necessary in order to maintain dimensional control. It performs the function of maintaining the exact shape in the vitrification process.

Materials for making vitrified clay sewer pipe must have well defined properties of plasticity and workability. They must be capable of being formed to close tolerances by mechanized and automated machinery in modern production lines. The formed product must be dried rapidly without cracking and distortion and hold their shape and develop maximum strength when fired to temperatures in excess of 2,000°.

Because vitrified clay sewer pipe must perform under stress from earth loads with high margins of safety, materials that develop high strength are absolutely essential. Minimum wall thicknesses, strengths and dimensional tolerances for every size of pipe are precisely specified. The manufacturer must therefore seek out and use only those materials that will enable him to attain these strengths and dimensional tolerances within the limits of permissible wall thicknesses. This again limits the number of usable materials.

In addition to all the requirements listed above there are others which every raw material must possess if it can be used in making vitrified clay sewer pipe. If a material carries more than minimum quantities of organic carbon compounds it cannot be successfully fired into a useful product. The presence of certain materials, such as pyrite (FeS_2), calcite ($CaCO_3$), and silica (SiO_2), beyond well defined small limits will instantly rule out a material.

Obviously the proper proportions of clay minerals and accessory minerals to permit forming and firing into an acceptable product, can vary only within rather narrow limits. If this combination cannot be found in one material source, the manufacturer must resort to combining materials from several sources.

To understand the problems of raw material selection some explanation of the origin of clays is in order. All usable clay and shale deposits are made up of rock disintegration products that have been transported and deposited at some distance from their origin. The source material was usually some form of igneous rock, which was extruded from the earth's interior in molten form and solidified on cooling. Such materials were extremely complicated mixtures of many varieties of minerals, and their chemical composition was erratic. Involved weathering processes extending over long periods of geologic time sometimes resulted in the formation of the clay minerals, as one ingredient in the altered mass. If proper conditions existed, the alteration products might be transported by water, wind, or glacial action to another location. Water transport was the principal method, with wind and ice playing a lesser role.

Whenever water or wind was the transporting medium, any reduction in velocity resulted in the coarser and heavier particles settling out more rapidly. This caused wide differences in composition and physical properties both horizontally and vertically in the new deposits.

Deposition may have occurred in localized areas as small isolated masses, or less frequently over wider areas in sheetlike masses. There was always considerable segregation of materials on a localized basis which resulted in widely variant chemical and physical properties.

Since deposition of clays and shales happened in very remote geologic times, almost every deposit has subsequently been subjected to erosion, folding, tilting and faulting. Leaching by ground water has further contributed to change for better or worse. The amount of rainfall in various sections of the country has had measurable effect on the end product. Clays in the more arid sections of the country are inclined to be alkaline, while those of great age in areas where there has been abundant rainfall may be acid in nature. Either extreme is detrimental. Glacial transport and deposition results in a hopeless conglomeration of material.

In any event the origin, transport, deposition, and subsequent alteration of deposits, renders it unlikely that any substantial proportion of the nationwide resources of clays and shales are usable. It is assuredly true that far less than one-hundredth of 1 percent of the earth's surface materials are clays of commercial value and only occasionally here and there will manufacturers find the right combination of materials.

Existence of this situation is evident from a Bureau of Mines news release in September 1962, which states in reference to the Bureau's work on clays and shales, "The Bureau's aim is to increase proven resources in areas of shortage for certain clays and upgrade reserve in marginal deposits." Even in Ohio where the clays and shales were considered abundant in times past, the State Geological Survey is planning a major reevaluation of the situation with extensive fieldwork to locate new reserves if possible.

The immediately previous discussion leads to the need for an understanding of how the industry is distributed and how this relates to the geological and geographical occurrence of raw materials.

Data on the geographical distribution of pipe production in 1960, as set forth in Department of Commerce Report issued by the Bureau of Census is shown below:

Geographic division	Tons of ware produced	Percent of total
South Atlantic	274,365	14.0
Middle Atlantic	158,704	8.1
East North Central	661,278	33.8
West North Central	199,185	10.2
East and West South Central	273,836	14.0
Mountain	56,639	2.9
Pacific	330,660	16.9
Total	1,954,677	

Obviously, distribution of production coincides to some degree with population and hence with market areas, but is tempered by substantial or complete raw materials deficiencies in some areas, as is shown on the map accompanying this report, derived from U.S. and State geological surveys.

Clays and shales usable in the manufacture of clay sewer pipe are confined almost exclusively to the deposits of Mississippian, Pennsylvanian, and Eocene ages. As a matter of fact principally to the latter two. Although large land areas have Pennsylvanian and Eocene clays and shales at or near the surface, many of these areas are not strategically located with reference to population density.

In the East and North Central areas the usable Pennsylvanian materials are frequently covered with other rocks which precludes their recovery except by underground mining methods that render costs prohibitive. In much of the area where exposure is such that open pit mining may be used, the quality is deficient or so erratic that usable material is scarce. The same may be said of areas in the South and Southwest where Eocene deposits exist.

The vitrified clay pipe industry on the Pacific coast relies entirely on Eocene materials, and they are scarce and scattered. Reserves are very limited and quality so variable that the manufacturer commonly blends a wide variety to attain controllable uniformity and extend his reserves. Producers in the mountain areas normally blend many materials secured from scattered and isolated sources. They must do this to maintain quality and extend reserves.

SUMMARY

Vitrified clay sewer pipe is a highly specialized product that must have very specific properties, and meet very rigid and severe use requirements.

The materials from which it is made must combine very definite characteristics. These properties may vary only within narrow limits. Variation beyond these limits makes production uneconomic or impossible.

The occurrence of materials in which the necessary properties are combined is limited.

Increasingly severe use requirements, automation of production processes, rising production costs, and the production of longer lengths of ware with special fittings and prefabricated joints, impose further limits on the raw materials that may be used.

The manufacturers are faced with dwindling reserves of clay, more expensive development programs, and the need for conserving presently available clay while they seek to locate, develop, and exploit new resources.

(Map entitled "Geological Formations at Principal Sources of Raw Material" was in color and could not be reproduced in hearings. Thus it was made a part of the committee files.)

STATEMENT IN BEHALF OF STRUCTURAL CLAY PRODUCTS INDUSTRY DEPLETION COMMITTEE, WASHINGTON, D.C., SUBMITTED BY NEILL BOLDRICK, CHAIRMAN, DEPLETION COMMITTEE

I. SUMMARY STATEMENT

We appear as representatives of the brick and tile manufacturing industry to ask correction of an inequity in both the depletion percentage rate now granted our industry and the point of application of that rate. We are currently operating under most inequitable legislation (the Gore amendment to the Public Debt and Tax Rate Extension Act of 1960) which was enacted without any hearings being permitted our industry to express our views or to point out the inequities created. The Gore amendment eliminated the previously court-accepted principle of "first commercially marketable product" and by establishing the arbitrary cutoff point at the pugmill destroying about 80 percent of the depletion established for brickmen by previous legislation and court decisions. This most drastic action has been a serious blow to the progress and economic stability of our entire industry.

We endorse wholeheartedly the principle of percentage depletion as an economic encouragement to the mining and mineral industries of our Nation. We want it established for the record that we in no case consider present rates excessive, and we sincerely hope that no legislation or regulations will be approved that will deny to any producer the presently established depletion allowances. Our request is that brick and brick and tile clay be increased in rate from 5 to 15 percent and that the point of application of this rate be, instead of at the pugmill, applied at the point of entrance into the kiln which would give us the same depletion now enjoyed by our most direct competitor, cement. Today in the marketplace of construction, the principal competition for the wall treatment lies between the cement and burnt-clay producers. Cement, under the depletion allowed limestone, is favored by a 15-percent rate and by application of this rate at the point much further along the line of production than that allowed clay producers under the Gore amendment. We have charts which we would like to have you see to illustrate certain points of direct comparison between clay and cement. The first illustrations show the origin and formation of clay and limestone (figs. 1, 2, and 5). Nature has been generous in creating limestone of the types used in cementmaking compared with the stingy distribution of clay. This map (fig. 3), illustrates comparatively, the relative abundance and scarcity of the two minerals. We also show on this map (fig. 4), the wide distribution of clay plants which must locate on clay beds for their raw materials and near markets because of the mass and weight of clay and its products involved in costly transportation. Figure 6 shows the number and location of cement plants.

It can be seen that usable brick and tile clay is scarce in nature. Compounding this scarcity is the inexorable spread of civilization. As towns in America located along rivers, grew up, and spread out, they covered vast areas of valuable

clay deposits, removing them forever from use. Today, science is being drawn on more and more in the constant search for suitable clays.

Though unevenly distributed, clay is found in many parts of the country. Because of this and the fact that clay's heavy mass which is a very low-priced commodity, limits the shipping distance and the marketing area for a given manufacturer's products, the U.S. structural clay products industry is decentralized in a large number of relatively small plants.

In a typical case, a manufacturer will locate his plant at or near the clay pit to minimize transportation costs. Since the clay from that pit will have a unique color and texture that cannot be duplicated with other clays, that manufacturer is out of business once that deposit has been exhausted. He then must locate a new deposit, build another plant, and begin all over again with an entirely new product.

Whereas suitable clay is scarce, limestone of the quality used in cement manufacture is a sedimentary rock of wide distribution. Usually of marine origin, it frequently consists of calcium carbonate derived from seashells formed and deposited on ocean floors over eons of time. Such shells, in fact, are still recognizable in many limestone deposits. In others, their derivation has been obscured by the action of waves and currents and by chemical action.

Limestone occurs on every continent in formations ranging from a few inches in thickness to hundreds of feet. It is especially abundant in the eastern two-thirds of the United States, which was once awash beneath ancient seas. Geologists and mining engineers, in fact, estimate that limestone of the quality used in cement plants is much more abundant in the United States than is clay.

Limestone is the chief constituent of hydraulic (portland) cement, which provides the structural clay products industry with its chief competition in every building market, as shown in the figure No. 7. The competitive imbalance between the two minerals is obvious: the scarcity of brick and tile clay and the problem created by its varying composition contrasted with the abundance of limestone and the fact that variations in quality of limestone when used for such purposes present less problems.

Figure 9 illustrates most clearly the similarity of the steps of production of clay products and of cement. It shows also how much more of the production process is permitted depletion application in cement than in a clay product. Our request is for the granting of depletion on clay production processing equal to that allowed cement producers. Figure 7 is displayed to illustrate the direct competition of the clay products to the cement products. We call your attention to the almost exact horizontal product mix of each of these industries. As you see, item by item, they offset each other. As you see also, from (fig. 8), ours is a small competitor in total dollar volume of business, number of employees, and size of plants.

We are that "small business" group that form the economic background for many small communities over the Nation. Relief from the present depletion restrictions would render needed stimulus to this cause of small producers. We realize that much testimony will be presented directly to the maintenance of present rates and depletion allowance. In the interest of equitable tax revision, we feel it is equally urgent to request for our industry restoration of a part of our recently denied depletion and to urge equity in adjusting our rate to overcome the competitive disadvantage recently placed against us. We will appreciate your consideration.

II. BRICK AND TILE CLAY

Origin

As has been seen, clay is the random creation of glaciers, wind, and water interacting on ancient rocks (figs. 1 and 2). Clay occurs in three principal forms, all of which have similar chemical compositions but different physical characteristics. They are: Surface clays, which may be the upthrusts of older deposits or of more recent sedimentary origin; shales, which are clays that have been subjected to intense pressures until they have hardened to a slatelike consistency; and fire clays, which usually contain fewer impurities than shales or surface clays and which have more uniform chemical and physical properties.

Very thorough testing of clay reserves must be undertaken to predict their performance in advance. This work entails a great deal of time and money and is becoming increasingly necessary as known reserves dwindle.

Properties

Clays are complex materials; surface clays and fire clays differ from shales more in physical structure than in chemical composition. Chemically, all three are compounds of silica and alumina with varying amounts of metallic oxides and other impurities. Although, technically, metallic oxides are impurities, they act as fluxes, promoting fusion at lower temperatures. Metallic oxides influence the color of the finished product.

To satisfy production requirements, clays must have plasticity which permits them to be shaped or molded when mixed with water and they must have sufficient tensile strength to maintain their shape after forming and drying. When subjected to certain temperature range, the clay particles must fuse together. In addition, uniform density, hardness, and regularity of form are necessary.

To control as much as possible any variations in the end product, manufacturers often adjust various ingredients. For example, silica will reduce shrinkage in the kiln, but too much will reduce the cohesion of the clay. Lower fusion temperatures can be made possible by the inclusion of carbonate fluxes, but they have a strong effect on color, as does iron oxide, which improves strength.

Scarcity

Usable brick and tile clay is scarce in nature and becoming scarcer as known deposits are exhausted and the urbanization of America continues to spread out over usable deposits, removing them forever from use. Available brick and tile clay in the United States, in fact, is estimated to be many, many times scarcer than limestone suitable for cement manufacture (fig. 3).

Mining and manufacturing processes

Once a clay deposit has been located, tested, and found suitable for brick and tile manufacture, the mining process begins. Surface clays and shales are mined in open pits through the use of power shovels or shale planers. Some blending of raw materials is done at this stage to obtain a uniform composition. A shale planer helps to get a well-blended mixture since it makes a uniform cut from top to bottom of the bank.

Once dug, the clay or shale mixtures are transported to storage bins in the plant, either by trucks or by rail. Raw materials equal to several days' production usually are kept in reserve.

The first step in processing clay is crushing, which breaks up large chunks and removes any stones that might be present. Crushing is done either in a granulator or by heavy conical rolls.

The clay next is ground in any of several types of grinders. In a typical grinding operation, huge wheels weighing 4 or 5 tons each revolve in a circular pan filled with clay, grinding and mixing as they pass. At this point, some plants then screen the clay by sifting it through an inclined vibrating screen. The clay is now ready for tempering.

The object of tempering is to process the clay into a homogeneous and plastic mass ready for molding into units of a desired shape. This is most commonly done by adding water to the material in a pug mill. The pug mill consists essentially of a chamber within which revolve one or two shafts with blades or knives which thoroughly reduce and mix (called pugging) the material.

Now the clay is ready to be formed, and one of two principal methods is used—either the stiff-mud or the soft-mud process, depending on the qualities of the clay itself.

In the stiff-mud process, the clay is delivered to an auger machine which forces the plastic mass out through a molding die in a continuous stream called a column, much like toothpaste from a tube. The die molds the mass into the desired shapes for brick, hollow tile, or other forms and, as the column is extruded, it passes through a machine which cuts it into the desired lengths. In the size of the die and in cutting to length, allowance is made for the shrinkage that will result from drying and burning.

Deairing is an important development in the stiff-mud process. It is accomplished by use of a deairing chamber attached to the auger machine, through which the clay passes. The clay is broken up and shredded as it enters this chamber, where a vacuum of from 15 to 29 inches of mercury is maintained. Some of the chief advantages of deairing are greater strength in the body both before and after firing, increased workability and plasticity, and better utilization of inferior clays.

The soft-mud process is used only for brick and is particularly well suited to clays which contain too much water in their natural state to be used in the stiff-mud process. The soft-mud process mixes clay with 20- to 30-percent water. When tempering is completed, the clay is pressed into molds by an automatic machine which sends the molds, presses the clay in, strikes off the excess, "bumps" the molds and deposits the molded brick onto pallets for drying.

In order to prevent the wet clay from sticking, the insides of the molds are either covered with a thin layer of sand or are dipped into water before the clay is pressed into them. Both sand-struck and water-struck brick derive from this process. Each method produces a characteristic surface texture.

Other brick finishes are provided by machine attachments which will scratch, roll, brush, or otherwise roughen the surface of the clay leaving the die.

After the brick or tile units are formed they must be dried before burning. As the units move off the cutting table, they are loaded onto dryer cars so that air can circulate freely around them. There are many different types of driers, but the purpose of any drier is to remove as much free water from the units as possible in the shortest possible time. The time required will vary with different clays but usually is from 24 to 48 hours. The heat and humidity in the dryer tunnels must be closely monitored during this period to prevent excessive cracking which would destroy the units.

A third method of manufacture, very little used in brick and tile manufacture today, is the dry-press process where clay in a nearly dry state is molded into shape under high pressure.

Burning is the next step in the manufacture of structural clay products and requires from 60 to 100 hours to complete. Several types of kilns are used, including scove, round periodic downdraft, and tunnel kilns. Fuel may be coal, oil, natural gas, or, in some cases, wood.

In the scove and periodic downdraft kilns, the dried units are set by hand according to a prescribed pattern that permits the free circulation of hot kiln gases. In a tunnel kiln, the units are loaded on special rail cars that move through the tunnel at a regulated speed.

The burning or firing of clay products may be divided into three general stages: Dehydration or water smoking; oxidation or blue-smoking, and partial vitrification or hardening. These stages accompany rising kiln temperatures and produce certain physical changes in the units. Temperature and the rate of temperature increase must be carefully regulated according to the type of unit and the characteristics of the clay. All kilns are equipped with recording pyrometers so that the burner can have a constant check on the firing process.

After maximum temperature has been reached, the kiln is allowed to begin cooling gradually. Sometimes this is preceded by flashing, a step which involves creating an atmosphere in the kiln insufficient for complete combustion. Done skillfully, flashing will produce different colors and shades of colors, depending on the type of clay being fired. Cooling usually takes 48 to 72 hours and the rate of cooling has an important effect on color, while units cooled too rapidly will crack and check.

After cooling the kiln is unloaded, the units are sorted and graded, and either loaded directly for shipment or sent to storage.

Clay depletion allowance

Minerals in the ground, whether solid, liquid, or gas, are a form of capital. When a mineral such as clay is extracted from the ground, the value of that clay deposit is to that extent depleted. And at the same time that the clay products manufacturer is depleting his mineral deposit, he is also depleting his plant, and he is also depreciating the expenditures he makes to promote the particular clay products coming from a particular clay deposit.

Congress more than 40 years ago recognized the depletion problem that faces producers in extractive industries when it enacted a discovery value depletion provision in the Federal income tax law. This was followed several years later by a more practical percentage depletion allowance, which continues in force to the present. In addition to the compensation of producers for the exhaustion of their reserves, the granting of depletion allowances also encourages the search for new reserves. This contributes to national wealth and purpose.

By the Revenue Act of 1951, the mineral brick and tile clay was, for the first time, granted a depletion allowance. The rate was limited to 5 percent of the gross income from mining. That depletion allowance and the point at which it was applied was carried forward without change into section 613(b)(5) of the 1954 code.

Why should a depletion allowance for brick and tile clay be applied at a point in the manufacturing process, rather than when the mineral is extracted from the ground? The answer to that question can be found in the following definition of gross income from the property. It was written into section 114(b)(4)(B) of the 1939 code by the Revenue Act of 1943:

"As used in this paragraph the term 'gross income from the property' means the gross income from mining. The term 'mining' as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but *also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products*." [Emphasis added.]

The same language was carried forward without change into section 613(c) of the 1954 code.

In the Senate report that accompanied the above-quoted provisions of the Revenue Act of 1943, the Senate Finance Committee stated:

"The purpose of this provision is to make certain that *the ordinary treatment processes which a mine owner would normally apply to obtain a marketable product shall be considered as a part of the mining operation.* [Emphasis added.] * * * The law has never contained such a definition, and its absence has given rise to numerous disputes. The definition here prescribed expresses the congressional intent of these provisions as first included in the law * * *. It is therefore made retroactive to the date of such original provisions."

The intent of Congress in granting a depletion allowance to brick and tile clay therefore was that it be applied at that point in the mining-manufacturing process where the first commercially marketable mineral was produced.

This was well understood by Senator Walter F. George, of Georgia, who was chairman of the Senate Finance Committee when the depletion allowance for brick and tile clay was written into the Revenue Act of 1951. In a letter dated June 4, 1955, to T. Coleman Andrews, then Commissioner of Internal Revenue, Senator George said:

"I personally recall the discussion in executive session between members of the Senate Finance Committee when this statute was under consideration. At the time it was not only understood but I pointed out what I knew and believed to be the facts about brick manufacture * * *. Brick clay at this time has no commercially marketable value until it is baked or cooked. The Senate Finance Committee certainly understood this clearly before the (1951 Revenue) Act, giving depletion allowance to brick clay, was passed * * *."

Regardless of the law and congressional intent, the Internal Revenue Service refused to recognize the first commercially marketable product as a finished brick or tile and clay manufacturers were forced to lengthy and expensive litigation in Federal courts to establish the right to a proper depletion allowance for the brick and tile clay. Over 50 Federal court cases were brought, including 1 Supreme Court case involving brick and tile clay. This litigation extended over a period of some 10 years. While the clay manufacturers were successful in all of these cases, the Internal Revenue Service refused to recognize the court decisions.

Finally, in a Supreme Court case involving depletion allowance on clay used for clay sewer pipe, the U.S. Supreme Court rendered a decision adverse to the sewer pipe manufacturer. Almost simultaneously, Congress enacted the so-called Gore amendment (Public Law 86-564, 26 U.S.C. 611, June 30, 1960), modified the Revenue Acts of 1951 and 1954 concerning clay depletion, and applied the 5-percent depletion allowance at the point after "crushing, grinding, and separating the mineral from waste, but not including any subsequent process * * *"—in other words, at the pug mill, a point at which clay is not salable and never has been.

Since brick and tile has no determinable value at this point, a 5-percent depletion allowance recognized at this point cannot be calculated without using some mathematical formula.

As shall be seen in a succeeding section, Congress has visited a double inequity upon the structural clay products industry in both the rate of depletion granted brick and tile clay and the point in the production process at which depletion is reckoned, as compared with limestone, the chief constituent of hydraulic (portland) cement, which provides the structural clay products industry with its chief competition (fig. 9).

Number of brick and tile clay plants, their distribution, number of employees, and dollar volume

At the present time there are an estimated 505 plants of relatively small size producing structural clay products (fig. 4). Their products include brick, hollow tile of all types, and architectural terra cotta, but do not include thin wall tile, sewer pipe, flue linings, or drain tile. Types of brick include building brick, facing brick, sewer brick, paving brick, and glazed brick. Hollow masonry units include structural clay tile and structural facing tile, both glazed and unglazed. Architectural terra cotta includes ceramic veneer and ornamental sculpture.

These plants occur in every State, but concentrate in such relatively clay-rich States as Illinois, Indiana, Iowa, Ohio, Pennsylvania, New Jersey, North Carolina, and Texas.

The 505 structural clay products plants employ an estimated total of 42,682 workers, largely in production. The estimated total value of brick and tile shipments in 1962 was $268 million (fig. 8).

III. LIMESTONE

Origin

Limestone is a whitish rock usually of organic origin (fig. 5). Much limestone is composed almost entirely of shells, shell fragments, or the remains of other sea creatures. The origin of other limestone deposits is often difficult to determine.

Properties

Except in the case of relatively small amounts of high purity limestone used for chemical and metallurgical purposes, the relative purity of limestone is not too important in determining its use. Because of this and its great abundance, limestone is widely used for a great number of purposes.

Abundance

Limestone occurs on every continent and provides ample evidence of the extent to which the seas once covered the land. In the United States, limestone is especially abundant in the eastern two-thirds of the country. Geologists and mining experts estimate that limestone of the quality suitable for cement manufacture is much more abundant in the United States than is clay (fig. 3).

Mining and manufacturing processes

Limestone is quarried by blasting, then loaded and transported to crushers. If intended for use in cement manufacture, shale is added at that point, usually in the proportion of one part shale to four parts limestone. After the limestone has been crushed and sifted through a vibrating screen, it is next pulverized in a hammer mill and stored.

Limestone is the chief mineral used in the manufacture of portland cement. In modern manufacture, a suitable mixture of limestone, shale, and other minerals is ground together either wet or dry in the proper proportions. If mixed wet, the resultant slurry is pumped into a series of large mixing tanks and from there it is pumped into the kiln. If mixed dry, the ground raw material is carried by a conveyor to storage bins, and from there it is fed into the kiln after it has been damped to control dust.

In either form the raw material enters the kiln at the top end close to the chimney and is met by hot gases. The raw materials thus are dried and, as the kiln revolves, they fall downward toward the clinkering zone. There, under high heat, elements of the limestone and shale partially fuse or "clinker" together. The clinker is removed, cooled, mixed with a little gypsum or water to regulate the setting time, and then is ground to the finished product—portland cement.

Limestone depletion allowance

Like brick and tile clay, limestone has enjoyed a percentage depletion allowance since 1951. Unlike brick and tile clay, however, limestone used in making cement has enjoyed a substantially higher depletion percentage—15 percent—and that percentage has been applied at a point in the portland cement manufacturing process—at the "introduction of the kiln feed into the kiln"—at which the portland cement industry enjoys a substantial tax benefit (fig. 9).

Number of portland cement plants, their distribution, number of employees, and dollar volume

Portland cement plants are relatively few in number, represent a considerable capital investment, and lend themselves to automated processes (fig. 6). These facts are reflected in Department of Commerce figures which show that, at the end of 1962, there were only 179 portland cement plants operating in the United States, yet their value of shipments totaled $1,104,905,000, although the estimated number of workers employed was only 30,833 (fig. 8).

Because the location of portland cement plants reflects high construction volume as well as available limestone deposits, the bulk of such plants is in the eastern half of the United States and on the west coast.

IV. THE DIRECTLY COMPETITIVE NATURE OF STRUCTURAL CLAY PRODUCTS AND PORTLAND CEMENT

Portland cement provides the chief competition for the structural clay products industry in every one of its markets (fig. 7). For every structural clay product there is a competitive concrete unit, assemblage of units, or application. Portland cement and its end products are also very competitive with structural clay products in price.

Contrasted with the portland cement industry's relatively few plants and large dollar volume, the structural clay brick and tile industry is composed of a large number of taxpayer companies located in every one of the 50 States. These small independent businesses compete with each other under highly competitive conditions and, therefore, it is traditionally an industry which operates with a very small margin of profit.

Consequently, any factor which creates for one of those businesses a substantial disadvantage in comparison with its competitors may well prove disastrous to that business.

V. CONCLUSION

It is respectfully requested that Congress correct two serious inequities that presently exist in the application of depletion allowances to brick and tile clay and to limestone used in making cement.

First, the structural clay products industry requests that the present 5-percent depletion allowance granted brick and tile clay be increased to 15 percent to remove the competitive advantage now given limestone, which enjoys a 15-percent depletion rate.

Second, it is requested that the point in the production process at which the clay depletion allowance is applied be advanced from the pug mill to the "introduction of the kiln feed into the kiln," which is the point just before the minerals are burned and the point at which the 15-percent depletion allowance for limestone currently used in cement manufacture is reckoned.

With these inequities removed, the delicate competitive balance that has existed between the structural clay products and the portland cement industries will have been restored.

(Illustrations 1 through 9 were made a part of the committee files.)

AMERICAN MINING CONGRESS,
December 5, 1963.

Hon. HARRY F. BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: During the hearings on H.R. 8363, much testimony was presented to your committee with respect to the percentage depletion and related provisions of the code. In the event that the committee gives consideration to this subject, the American Mining Congress, on behalf of its cement industry members, would like to have the following information with respect to the cement industry included as part of the record.

1. *Limestone usable for cement manufacture is, from both an economic and a chemical standpoint, a scarce mineral.*—The chapter on "Cement Materials" in the volume entitled "Industrial Minerals and Rocks," third edition, AIME, 1960, at page 210, has the following statement concerning cement limestone:

"Such limestones are by no means common, as any geologist who has searched

for raw materials suitable for the cement industry will attest. Many limestones, widely distributed and occurring in billions of tons, contain too much magnesia to qualify, at least until present beneficiation methods have been improved."

The fact that limestone used in the manufacture of portland cement has to be low in magnesia rules out dolomite and dolomitic limestone, which constitute perhaps 70 percent of the broad category of limestones. Much of the remaining 30 percent is not acceptable for cement manufacture because its use is restricted by limitations as to the amount of silica present and by the fact that alkalis such as sodium and potassium are limited by specification to less than six-tenths of 1 percent in the finished cement. Furthermore, while some argillaceous material is desirable in limestone used for making cement, there is a limit on the proportion thereof that can be present.

An economically usable deposit of limestone for cement manufacture must have the following characteristics: (1) a composition which does not vary too widely from the acceptable limits for calcium carbonate, magnesia, silica, and alkalis; (2) uncontaminated by numerous beds of sandy, clayey, or dolomitic stone; (3) relatively little overburden; (4) in an area free from zoning restrictions but near to transportation, labor sources, and markets, and (5) reserves of sufficiently large quantities to justify the huge capital investment required to mine the deposit and process it into cement.

Attached hereto as exhibit A is a more detailed description of the chemical requirements for limestone for use in the production of portland cement.

2. *The mining processes allowed in computing "gross income from mining" for determining depletion deductions on cement making minerals are in accord and fully consistent with long-established Treasury practice.*—In computing the percentage depletion deduction for limestone and other minerals used in making cement, the cement industry is permitted under section 613(c)(4) to include as part of mining "all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent processes." Under this provision the cement industry is thus allowed only the processes of crushing and grinding the limestone and other minerals (plus an insignificant amount of blending before they are put into the kiln for burning into clinker).

Crushing and grinding have historically been considered ordinary treatment processes for minerals under the depletion laws. Thus, the Treasury Department, in 1953, recognized crushing and grinding as ordinary treatment processes in computing the depletion deduction for the cement industry in Rev. Rul. 290 (1953-2 C.B. 41). The same position was again taken in its proposed legislation in April 1958 to the House Ways and Means Committee, and in its proposed legislation in 1959 to both the House and Senate. This policy was also embodied in the legislation enacted in 1960 (Public Law 86-781) relating to cement depletion for the period from 1951 through 1960.

Because there is no actual market at the kiln feed cutoff point, the proportionate profits method of computing percentage depletion is employed for cement minerals. Since the cost of the processes after the cutoff point is about two-thirds of the total cost of making finished cement, this method results in the industry having a cutoff point about one-third of the way through the cement-making process.

We are available to furnish any additional information on this subject which your committee may desire.

Respectfully submitted.

H. A. SAWYER,
Chairman, Cement Advisory Committee.

EXHIBIT A

[National Bureau of Standards, Washington, D.C., Dec. 19, 1951]

MEMORANDUM RE REQUIREMENTS FOR CHEMICAL GRADE LIMESTONE FOR USE IN THE PRODUCTION OF PORTLAND CEMENT

(By Dr. Robert H. Bogue, director, Portland Cement Association Fellowship)

The chemical grade limestone required for the production of portland cement must be of special quality, with definite limitations on the content of various constituents other than lime (CaO). These limitations are the result of the exacting specifications for portland cement, as found in the Federal Specification SS-

C–192 and the ASTM Specification C–150–49. It will there be neted that the specifications for the five types of portland cement carry limitations on the following chemical oxides or compounds:

Silica (SiO_2)
Alumina (Al_2O_3)
Ferric oxide (Fe_2O_3)
Magnesia (MgO)
Sulfur trioxide (SO_3)
Tricalcium silicate ($3CaO.SiO_2$)
Dicalcium silicate ($2CaO.SiO_2$)
Tricalcium aluminate ($3CaO.Al_2O_3$)
Soda plus potash (Na_2O+K_2O)

In addition, small amounts of certain oxides, notably the alkali oxides, may affect profoundly the process of cement production and the acceptability of cement under these specifications. There are also limitations on insoluble residue, heat of hydration, soundness, time of set and physical properties, all of which are dependent upon the chemical composition of the raw mixture from which the cement is made.

The above multiplicity of limitations narrows the permissible variation in chemical composition of a raw mixture for cement production to a restrictive range. Where so many of the oxides and compounds are delimited, the oxide ratios that can be tolerated in the raw mixture are confined to narrow zones.

I have spoken thus far only of the raw mixture, but more than four-fifths of the raw mixture is usually limestone. In determining the suitability of a limestone for the production of portland cement, it is necessary at the same time to consider the other materials that are available for adjusting the composition to add certain desired constituents. These usually will include clay or shale. Sometimes other materials as marl, sandstone, slag, iron ore, etc., are added. In no case however can a material excess of a detrimental constituent in the limestone be corrected by such admixture. The producer is under the unalterable necessity of making from the raw material available to him a cement that will conform to the specifications referred to above.

The chemical requirements of the limestone for cement production are given in the following table, on the assumption that the limestone is the whole raw material. This may result in a too-liberal specification for the limestone, and the actual specification in a given case may need to be more restrictive. The table shows the chemical limitations on limestone for use in the production of the five recognized types of portland cement, under the above assumption, and with the arbitrary condition of 36-percent ignition loss, a reasonable average.

	Type of cement to be produced				
	I	II	III	IV	V
Alumina: Al_2O_3 (maximum)	4.8	3.8	4.8	3.8	2.6
Ferric oxide: Fe_2O_3 (maximum)	3.8	3.8	3.8	4.2	2.6
Magnesia: MgO (maximum)	3.2	3.2	3.2	3.2	2.6
Alkalies such as Na_2O (maximum)	.4	.4	.4	.4	.4

NOTE.—The remainder of the composition must be lime and silica in such proportions as are needed to meet the requirements for tricalcium silicate and dicalcium silicate.

Each of the figures given above represents a theoretical upper limit on the tolerances allowed. In practical operation it is necessary that these limits be further restricted to allow for normal fluctuations in the flow of the material through the plant. Also to be considered are the percentages of constituent oxides introduced into the cement from the ash of the coal used in burning the clinker. Not considered in the above tabulation is a practical, necessary limitation in phosphorous pentoxide (P_2O_5) of about 0.2 percent. Likewise, the content of SO_3 in the finished cement is usually limited to 2.5 percent, thus barring the use of limestones with an appreciable content of gypsum or other sulfates. All of these restrictions place further limitations on the acceptability of a limestone for the production of portland cement.

The limitation on magnesia is particularly worthy of note. In view of the very common association of magnesia (GoO) with calcium oxide (CaO) in limestone, this is a very decided limiting factor on the availability of limestone generally for portland cement production. Dolomites, though occurring in large tonnages in many areas, and though used in many places for the production

of lime and in certain other chemical as well as metallurgical applications, cannot be used for the production of cement.

From the above it is clear that the chemical limitations on the limestone for the production of portland cement are highly exacting, and rule out a wide range of limestones which may be suitable for other purposes. In this connection it is worthy of note that 4 of the 26 limestones reported by Meade ("Portland Cement," Chemical Publishing Co.) as being used for cement production in 1926 are now no longer available, due to the more exacting specifications of the present period. Other reasons for abandonment of quarries are depletion of rock of suitable quality, increased cost of working, and expansion of urban restrictions.

It is probable that many deposits of limestone of suitable quality for cement production are still untouched, but their inaccessability or distance from metropolitan centers make their development uneconomical. Of suitable available deposits, I am of the opinion that depletion is already a serious problem.

Reference may be made to a report by Dr. Kenneth K. Landes on "Metallurgical Limestone Reserves in the United States," under date of February 5, 1949, as filed with the Ways and Means Committee of the U.S. House of Representatives and the Finance Committee of the U.S. Senate. A reading of this report makes it clear that Dr. Landes was discussing primarily limestone for metallurgical use in the iron and steel industry, with incidental reference to limestone of a similar character used in certain chemical industries. Dr. Landes limited his discussion to the particular types of metallurgical grade limestone and chemical grade limestone used for the purposes specified, and did not attempt to discuss the important chemical grade of limestone required for use in cement production. The facts which I have set forth above make it clear that the limestone required for cement production must meet fully as precise and exacting chemical specifications as the limestone required for those metallurgical purposes or chemical purposes to which Dr. Landes referred.

The chemical grade limestone required for cement production is a highly important natural resource, limited in occurrence and in available reserves. Such limestone, since it must meet rigid requirements as to chemical composition, is certainly to be included within the ordinary meaning of the term "chemical" grade limestone."

(The following letter with accompanying memorandum was submitted by Mr. Charles W. Stewart, president, Machinery & Allied Products Institute, Washington, D.C., in compliance with a request made of him by Senator Everett Dirksen on p. 997 of pt. 3 of the printed hearings.)

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., December 12, 1963.

Hon. EVERETT M. DIRKSEN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DIRKSEN: You will recall that on October 28, 1963, during the oral presentation of the Machinery & Allied Products Institute before the Committee on Finance of the U.S. Senate in public hearings on H.R. 8363, the proposed Revenue Act of 1963, you requested that I submit on behalf of the institute detailed language suggestions to implement our recommendation that section 1 of H.R. 8363 be modified and made more definitive. Accordingly, we are pleased to submit to you and to the Committee on Finance suggested language as set forth in the attachment to this letter.

You will note that in the enclosure we have reproduced the language of section 1 in the form approved by the House of Representatives, our proposed revision of section 1, and explanatory comment relating thereto. We appreciate that these suggestions not only should be reviewed from a policy standpoint, but also must be examined technically by expert staff experienced in statutory draftsmanship. We hope, however, that the concepts and ideas embodied in the proposed language will be helpful.

So that official committee records may be complete, I am sending a copy of this correspondence to the chairman, Committee on Finance, Hon. Harry F. Byrd, and to Mr. Colin F. Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

Respectfully,

CHARLES W. STEWART, *President.*

POSSIBLE REVISION OF SECTION 1 OF H.R. 8363

Section 1 of H.R. 8363. Declaration by Congress (as passed by the House of Representatives)

It is the sense of Congress that the tax reduction provided by this act through stimulation of the economy, will, after a brief transitional period, raise (rather than lower) revenues and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. To further the objective of obtaining balanced budgets in the near future, Congress by this action, recognizes the importance of taking all reasonable means to restrain Government spending and urges the President to declare his accord with this objective.

Section 1 of H.R. 8363. Declaration by Congress (as proposed by Machinery Institute in response to Senator Dirksen's request during public hearings)

It is the sense of Congress that the tax reduction provided by this act, through stimulation of the economy, will, after a brief transitional period, raise (rather than lower) revenues, and that such revenue increases should first be used to eliminate the deficits in the administrative budgets and then to reduce the public debt. Since the purpose of the tax reduction is to enable individuals and business enterprises to stimulate the economy through increased private expenditure, it is unnecessary to stimulate it also through increased public expenditure.

It is recognized that deficits will not soon be eliminated if Government spending continues to rise at the recent rate. Accordingly, the objectives of the tax reduction require that such spending be severely restrained and if possible reduced. Indeed, the tax reduction program is enacted on the assumption, and with the determination, that this restraint will be exercised. Wasteful, inefficient, or unessential Government activities cannot be supported, because they incidentally give employment, nor can even essential activities be justified for this reason.

It is, therefore, the sense of Congress that, barring any unforeseen national emergency, congressional appropriations and Federal spending during the transitional period of lower revenues resulting from this act shall not exceed in any fiscal year during this period amounts appropriated and expended in the fiscal year 1964. The concurrence of the President of the United States in the spirit of this statement is recognized, and his continued support is respectfully enlisted.

Explanatory comment regarding proposed revision of section 1 of H.R. 8363

It is the purpose of this proposed revision of section 1 of H.R. 8363 to incorporate the gist of that extension and elaboration of the section's intent expressed by Chairman Mills of the House Ways and Means Committee in his statement in the House on September 24, 1963. We concur with that statement and think its inclusion in statutory language desirable.

It is the further intention of this proposed language to establish measurable standards to be applied in restraining both appropriations and spending in a manner consistent with the spirit of section 1, H.R. 8363. We recognize, of course, that the language here suggested may require revision by experienced legislative draftsmen; however, it has the virtue of providing fixed and reasonable standards not included in the original version of section 1. We think, also, that it raises no constitutional problems involving a congressional abdication of legislative responsibility, since it is intended to be incorporated within the framework of a statement of the sense of Congress.

(Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, December 10, 1963.)

REVENUE ACT OF 1963

TUESDAY, DECEMBER 10, 1963

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

The committee met, pursuant to recess, at 11 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Talmadge, Ribicoff, Williams, Carlson, Bennett, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order. We have before us the very distinguished Chairman of the Board of the Federal Reserve System, Mr. Martin. Senator Dirksen requested him to come to answer certain questions. The Chair recognizes Senator Dirksen.

STATEMENT OF WILLIAM McC. MARTIN, JR., CHAIRMAN OF THE BOARD, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; ACCOMPANIED BY GUY E. NOYES, DIRECTOR OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Senator DIRKSEN. Thank you, Mr. Chairman. Mr. Martin, I want to apologize for delaying this meeting until 11 o'clock, but I was called to the White House for a 10 o'clock meeting. I know you will understand. It is good to see you here. I do not get to see too much of you.

When Mr. Dillon was before the committee I pursued a brief line about financing the budget and the impact of the tax reduction proposal and how this deficit is going to be financed.

There are some who believe that we will not achieve a balanced budget until 1972 and that, of course, raises the question of how that is going to be financed, whether it be through the banking structure or through savings or in some other way.

Now, I think it is quite apparent that our money supply is probably at a level of, say, $150 billion. Demand deposits have changed, they are moving into a more lucrative field of financing, they are getting into riskier loans. And I would think that in that kind of a situation where any kind of a shock could really stop the market, and to get back to the question of assessing our capacity to finance this deficit, whether it will have an impact on long-term interest rates, whether it could have an inflationary effect.

Now, I just leave that up to you to discuss and knowing that the last time you did discuss the question of imbalance of payments,

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whether you might want to add some observations—in other words, I leave you free to discuss this.

Mr. MARTIN. Well, Senator Dirksen, I would like to start out by saying that the Federal Reserve has no desire to limit in any way the effect insofar as stimulating the economy that may come from a tax reduction. We have a duty and responsibility to prevent inflation, and inflation is a very real problem.

The reason we are against inflation is because we know that it leads to deflation. In fact, one of the reasons why we have had difficulty over recent years has been that inflation got ahead of us and we created more capacity than we utilize at profitable prices, cost-price relationships and the effect was it resulted in unemployment that would not have been there if we had not had that depreciating inflation.

Now, financing this deficit is always a difficult thing. I have repeatedly stated that I think that deficits should be financed insofar as possible out of bona fide savings. However, you must remember that the Federal Reserve System was created to make adjustments in our money supply and that we have to use our judgment to provide whatever reserves we think the economy can use without having inflation and if we provide reserves in excess of what we think the economy can use—without inflation—either for the purpose of facilitating Treasury financing or for the purpose of making it possible for the Treasury to finance at a lower interest rate than they may otherwise have to pay in the open market, we are in substance printing money.

Now, we have been exceedingly fortunate in the last year or two in that the rettained earnings and depreciation allowances of corporations and the savings flow have been sufficient to cover our deficit. Although there may be a few hundred million dollars more or less a year, in a technical analysis, nevertheless, the fact remains that we have been succsesful in financing this deficit to date in an uninflationary way.

In other words, the banks today hold less Government securities than they did a year ago. Now, that does not mean, if this tax reduction goes through, that we may not come to a point where the burgeoning demands for credit and the requirements to finance the public sector will be in excess of available savings and at that point interest rates will tend to rise. As you can see, it depends upon the state of the economy.

I think that the thing that we have to recognize here is that we have a balance-of-payments problem. You have given me wide latitude in your question and we have three points here. We want to reduce unemployment. We want to promote growth and we want to bring about equilibrium in this balance of payments. These are not three separate problems. In my judgment, they are one and the same problem, and it requires a mixture of policies in order to attain those ends.

Now, the reason we engage in deficit financing, and let me make it clear that I don't like deficit financing, is that under certain circumstances deficit financing can be useful and can contribute something to the economy but it is only for the purpose of bringing us back to normal. I do not think there is anything bad about the word "surplus," and I don't think there is anything good about the word "deficit."

I think both of them have to be used in relation to our objective of creating a balance in the economy and I think that there are limits to which you can use deficit financing to promote growth and reduce unemployment. This is the big problem that we have been struggling with and I think that so far we have been able to do pretty well, but I think that the test will lie ahead of us.

And I may just make the general comment that I don't think it is up to the Federal Reserve to pass on whether this tax bill is sound or unsound. That is not our prerogative. But insofar as it affects our problem of financing, I would like to emphasize that the success or failure of the bill in terms of helping the economy will depend upon whether it creates incentives for people to do more than they would otherwise do, or to save or to spend more money than they otherwise would save or spend, and this relates to the flow of funds.

Let me put it this way. You may have an individual who gets a tax reduction who will use the tax reduction to buy a savings bond, which would be financing the Government. Now, some economists will say that that completely destroys the effectiveness of the tax reduction, but I don't for a minute believe that because here you are dealing with psychological confidence factors and surely that man is going to feel a lot better because he has a thousand dollars in a savings bond. The flow of funds, which is the movement of funds into active assets which will create jobs and promote growth, the growth that we are talking about as being sound, is really the objective and purpose of what we are trying to do. It is in the area of the flow of funds that we have our primary concern.

Now, the Federal Reserve is anxious and willing to do everything we can to see that the economy is properly stimulated but it certainly cannot perform miracles. And if I may just make a general comment, I think that in recent years we have come to rely too much on monetary policy and ask it and ask us to do more things than it can reasonably be expected to do.

As far as the balance of payments itself is concerned, we have made progress on that, and the move we made last summer on this has narrowed the differential between short-term rates abroad and short-term rates in this country so as to minimize the incentive for people to transfer funds against us. We have got to bring about a reasonable balance between our spending and investing abroad and spending money and investing it in this country, and I believe that what has been done has been helpful.

On the other hand, we did not want to neglect the importance of strengthening and developing the economy. When you are talking about credit, which is really what is involved in the broad sense, my favorite illustration is that credit is like a rubber band, because it is there to be stretched, but if you stretch it too far, it will break. When we turn to deficit financing with bank credit it is not a dollar-for-dollar matching, but the creation of new money, and if you start the printing press going it becomes self-defeating, both in the confidence angle of the economy and insofar as creating new jobs in the economy, which is our purpose and objective.

Now, that sounds a little bit like going around the switch, but I wanted to cover your question, Senator, in as simple a way as I could.

Senator DIRKSEN. Well, it occurred to me that if we did achieve

one of the prime objectives of this bill; namely, to stimulate capital investment and expansion of industry for the purpose of helping in the problem of unemployment, obviously, we are going to need money——

Mr. MARTIN. That is right.

Senator DIRKSEN. The question then is, Where are we going to get the money? Now, those who have the money may hold out to see the impact on the interest rates, when you have two businesses, government and industry competing in the money market——

Mr. MARTIN. There will be a tendency for the interest rates to rise, not because of Federal Reserve policy, but because of market forces and pressures in the economy, and if the Federal Reserve at that point steps in just to create additional money for the banking system, we would be imperiling this credit mechanism that I am talking about, leading ultimately to inflation and depreciation of our currency.

Senator DIRKSEN. And, of course, if we got inflation, that would be self-defeating, if you give the average taxpayer a $80 or $90 saving on taxes, he might very conceivably lose that in the form of inflation.

Mr. MARTIN. No question at all about that and I have thought quite a bit about this in recent years. In 1955 and 1956 we were increasing our gross national product by roughly $1 billion a month without any additional goods and services being created and over the past year we had an increase in our gross national product, our national product of about 6 percent and consumer prices have gone up roughly about 1 percent and actually wholesale commodity prices have tended to decline, so that virtually all of this increase has been net addition to goods and services in the economy.

Now, this is exactly what we ought to try to continue to do. But we certainly cannot do that if we start in motion again an inflationary process. I might point out that inflation is a process that goes on by money creation and only has as its end result a price rise.

People are constantly saying to us, "Well, where is the inflation if prices are not rising?" Well, if the money supply is being increased inordinately without any relation to the flow of goods and services, just to cover a Treasury deficit, it is just a matter of time before prices begin to rise.

Senator DIRKSEN. Well, our discovery is that we have not learned one elementary economic lesson. When we talk about prices going up, actually the purchasing value of the dollar goes down, and that is a lesson that we simply have not learned.

Mr. MARTIN. That is right. I talked to a group in New York last night—I pointed out to them that the role of the Federal Reserve in this sort of thing is never going to be a popular one—we are always put in the position of the chaperone who takes away the punch just when the party is getting good. [Laughter.]

And we certainly are not going to win friends and influence people in that way.

Senator DIRKSEN. Would you like to amplify your comments on the matter of the imbalance, the matter that you did discuss at New York. I would gather that there has been some improvement in our situation, on an annual rate, in this balance-of-payments situation. I would like to have your comments about that.

Mr. MARTIN. Well, between the second quarter of this year and the third quarter of this year, we have just about cut the deficit which had increased alarmingly in the second quarter, in half. It is too early in this quarter to make any conclusions. But I think that we are far from having licked this problem and we have got to work on it very quickly again.

It is not a precise balance that we are seeking, it is a trend toward balance and in that respect I think that we can take real encouragement from the movement from the second quarter into the third quarter. But we still have to confront the fact that we must conserve our gold—not because gold is good in and of itself, but because it is the only means of international exchange that we have. Insofar as any ultimate changes in the system are concerned, we certainly do not want to make any changes because we have not been able to live up to our contractual engagements. That would mean receivership for the United States of America, and that is really why it is so important that we solve this broad problem of our balance of payments.

Now, we have been successful in the last few years in maintaining relatively stable long-term interest rates without much additional pressure on them.

And I want to say here, and I will always testify, that we are not for high interest rates per se. I personally want to see as low an interest rate as it is possible to have without having an inflation, because I think that we will get the maximum capital formation that way. But I certainly do not think that we should offset upward pressure on interest rates in order to facilitate Treasury finance. If the only way to keep interest rates down is to add to the money supply through bank-created funds—and that would be stretching this credit that I described as being like a rubberband, to the breaking point—it would have an impact on the price level which would be dangerous and would leave our purchasing power impaired.

Senator DIRKSEN. Now, do you believe that we can manage these deficits?

Mr. MARTIN. I do. I think we can do it but we must always face up to the fact that this may lead to higher interest rates. We do not want them to rise inordinately, and I still hold to my view that what we want is as low a long-term interest rate as we can have without providing inflation, but we have no other mechanism than the interest rate to bring savings and investment in equilibrium.

Senator DIRKSEN. Now, I have one specific question with respect to the tax bill and you may or may not want to answer and if you do not it is perfectly all right. It relates to the limitation on adjustments for capital loss. Now, do you take that as one of those limitations which discourage capital investment?

Mr. MARTIN. I would rather not comment on that, Senator, because this gets into the details of this tax bill. It seems to me that the Federal Reserve ought not to be in politics. I do not think I am foolish enough to think that money is not in the political arena—but on the specifics of a tax bill, it seems to me that if we start commenting on any specific item, that then I would have to be prepared to go into all of them.

Senator DIRKSEN. Well, that is perfectly all right. I do think that it presents a real problem in relationship to the bill that is before us.

The hope is to get some incentive—and we may not necessarily get it in the so-called risk industries.

Now, clearly, if a man has the money and he can sell his blue chips, he may decide to put his money into a somewhat riskier endeavor. But for him to do that, there has to be some incentive. But if he looks at the tax laws he is likely to say, "Well, if I lose I can only deduct $1,000 a year of my losses," and that simply is not enough inducement to go into a new risky endeavor. Now, we have always referred to that kind of capital as risk capital, and if you want money to go into that kind of a line of endeavor, then you have got to put in some kind of provision that would afford some inducement and we have to look closely upon some of these limitations.

Mr. MARTIN. Well, I would simply reiterate my view that the success or failure of this entire tax bill will depend upon what incentive it gives to people to do more than they would otherwise do, either in saving more money than they would otherwise spend, and if they do so, then I believe it will stimulate the economy and should ultimately and eventually help get us into a balanced budget and, I hope, sometime, a surplus.

Senator DIRKSEN. Thank you, Mr. Martin. I believe that is all, Mr. Chairman, thank you.

The CHAIRMAN. Mr. Martin, I have been asked by one of my constituents to bring here these two $1 bills.

Now, one of them is the so-called silver certificate. It says that there is on deposit in the Treasury of the United States the amount of $1 in silver payable to the bearer on demand, and this particular bill is of the issue of 1935.

Now, the other is 1963. And this 1963 issuance of this $1 bill, it comes as a Federal Reserve note and it says nothing in regard to silver or payment on demand, but it does say that this note is legal tender for all debts public and private.

Now, Mr. Martin, would you explain why this change was made in issuing the paper money on the basis of Federal Reserve notes?

Mr. MARTIN. Well, we are rather pleased with this new note, Senator, and we have spent a little time on the design. [Laughter.]

We think that it looks better than the old silver certificate. But the real basis for it is that we had a sort of bimetallism until the Congress this year gave us authority to change. Now, we have all or practically all of our currency on the same basis. $50, $20, $10, and $5 bills were Federal Reserve notes before. But the silver certificates were backed specifically by silver.

The price of silver has reached the point where there is no longer any reason to keep the price up. It was reaching the point where a person who had a silver certificate could go and get the silver itself and melt it down and make a profit on it, which was not contemplated in the issuance of the silver certificates. The Congress has given us permission to substitute the Federal Reserve notes for silver certificates.

We have to back the new $1 Federal Reserve notes with gold at the 25-percent statutory requirement. That means that a portion of the reserves, our reserves that were covered by silver, now has to be covered by gold. But this will be done on a gradual basis. I am not too good at remembering figures, I have forgotten exactly what it amounts

to, but I think it runs something like $35 million will be required for this year in gold reserves to cover the silver certificates that will be issued.

The CHAIRMAN. And is that set aside, is that gold set aside in backing these $1 bills?

Mr. MARTIN. Yes, sir.

The CHAIRMAN. It does not say that on the bill.

Mr. MARTIN. Well, it does not say that on any Federal Reserve note—the $5 bill nor the $10 bill——

The CHAIRMAN. Well, it does say on the other bill that there is $1 in silver on deposit in the Treasury of the United States payable to the bearer on demand.

Mr. MARTIN. Well, it means that the silver market has got into a position where you could have people getting silver dollars and melting them down. I would be glad to provide for your constituents a copy of the release that was put out when the new bill was issued.

The CHAIRMAN. How many million dollars are involved on this basis?

Mr. MARTIN. I do not know. Do you, Mr. Noyes?

Mr. NOYES. I do not.

Mr. MARTIN. I can get the figure for you. But it is done on a gradual basis, you see, over the period of the next few years as the old certificates are returned.

(The following was later received for the record:)

Over the period approximately $1.8 billion of silver certificates, mostly $1 bills, will be replaced by Federal Reserve notes.

The CHAIRMAN. When did you start this change?

Mr. MARTIN. Oh, within the last 2 or 3 weeks, we started the changeover.

Senator BENNETT. May I make a comment, Mr. Chairman?

The CHAIRMAN. Yes.

Senator BENNETT. I come from a silver State and was involved in this change of the law. The problem is that the price of silver got so high—not that it was so low, but it got so high that we could no longer afford to keep enough silver on hand to back these silver certificates if the day ever came when we had to go on the market to buy the silver.

We have another problem. We need silver for quarters and 50-cent pieces and dimes. And so in order to save the Treasury's existing stock of silver and to make it available for small coins when it is needed, since there is more silver being used in the world than is being produced today, and this has been the case for a number of years, we decided and the Congress approved, a change in the law which no longer requires that our dollar bills be strictly silver certificates. It allows the Federal Reserve to issue them with a gold backing.

The CHAIRMAN. As I understand the Chairman, it is backed by gold.

Senator BENNETT. That is right.

Mr. MARTIN. That is correct, Senator. We will be glad to give you our release on that.

The CHAIRMAN. Yes, I would like to have you furnish that.

(The following was later received for the record:)

[Press release, Federal Reserve, Nov. 26, 1963]

The Board of Governors of the Federal Reserve System and the Treasury Department announced today that more than 50 million new $1 Federal Reserve notes are going into circulation. Issuance of the new $1 notes, authorized by Congress last June, has already begun at all 12 Federal Reserve banks and their 24 branches to commercial banks in every part of the country. This will make more silver available for coinage purposes and help to meet the increased demand for currency in connection with pre-Christmas business.

To facilitate the widest possible distribution, the initial supply of the new notes is being distributed through normal commercial banking channels; none of the first 50 million notes will be available to the public at any of the Federal Reserve banks or branches.

The new $1 Federal Reserve notes closely resemble the present $1 silver certificates, which ultimately they will replace completely. The back of the new notes and the portrait of George Washington on the face will be exactly the same as the silver certificates. The main difference will be the addition of a symbol, appearing to the left of the portrait, identifying the issuing Federal Reserve bank, and the wording on the face of the bill. The notes bear the signatures of the Secretary of the Treasury and the Treasurer of the United States, as do Federal Reserve notes of other denominations.

The new notes will read (above the portrait): "The United States of America" and (below the portrait) "One Dollar." The legend stating that the bill "Is Legal Tender for All Debts, Public and Private," appearing on the silver certificates will also appear on the new Federal Reserve notes, but the new notes will not contain any reference to silver. Thus, they will not carry the language: "This Certifies That There Is on Deposit in the Treasury of the United States of America" (above portrait) and "One Dollar in Silver Payable to the Bearer on Demand" (below the portrait).

Federal Reserve notes have been the basic circulating currency of the United States for many years, comprising over 85 percent (more than $30 billion) of the face amount of all currency in circulation today. They are backed 100 percent by collateral in the form of gold certificates, U.S. Government securities, or short-term paper discounted or purchased by the Federal Reserve banks.

Senator CARLSON. Would the Senator yield?

The CHAIRMAN. Yes.

Senator CARLSON. Mr. Martin, you referred back a while ago to the requirement for backing by gold, the 25 percent statutory requirement for gold. Now, is this 25 percent requirement for gold based upon statutory law or is that a regulation?

Mr. MARTIN. No; that is statutory law. That is in the Federal Reserve Act. The original act provided for 40 percent and then in 1946 the Coongress adjusted it to 25 percent.

Senator CARLSON. And that 25 percent can only be eliminated by action of Congress, is that correct?

Mr. MARTIN. That is correct; it can only be eliminated by action of Congress. The Federal Reserve Board is given authority to suspend the requirement for periods up to 30 days and renew the suspensions, which would give time for Congress to review the entire matter if the problem should become acute.

Senator CARLSON. The reason I raised that point is that the suggestion was made, I think by the Secretary of the Treasury, that this 25 percent requirement could be suspended without any action by the Congress.

Mr. MARTIN. The Federal Reserve Board has the authority to suspend for a period of 30 days. We can suspend it against deposits without any significant penalties. And if it goes down still lower, then we are required by law to raise the discount rate.

It is a rather complicated procedure, but I can give you a summary of the entire procedure, Senator, which we furnished to the Joint Economic Committee recently at Senator Douglas' request.

Senator CARLSON. I wish you would.

Mr. MARTIN. I will send it to you.

(The following was later received for the record:)

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
Washington, D.C., November 5, 1963.

Hon. PAUL H. DOUGLAS.
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your letter of October 21, 1963, in which you asked for certain information regarding the 25-percent gold certificate reserve requirements specified in section 16 of the Federal Reserve Act, with particular reference to action the Federal Reserve might take if the reserves should fall below the required amounts.

Paragraph 3 of section 16 provides that each Federal Reserve bank shall maintain reserves in gold certificates of not less than 25 percent against its deposits and reserves in gold certificates of not less than 25 percent against its Federal Reserve notes in actual circulation. The Board of Governors has authority, under section 11(c) of the Federal Reserve Act, to suspend these requirements in order to provide time for corrective adjustment, should the reserves fall below required levels. Section 11(c) also requires the Board to impose a graduated penalty tax on Reserve banks experiencing a reserve deficiency. The Board could comply with this requirement by imposing a nominal penalty tax, so long as System holdings of gold certificates did not fall below 20 percent of Reserve bank liabilities on Federal Reserve notes outstanding. For any deficiencies of reserves below this level, the law requires the imposition of a tax graduated upward from 1½ percent per annum. The discount rate of any Federal Reserve bank so penalized would have to be raised correspondingly. The text of section 11(c) follows:

"SEC. 11. The Board of Governors of the Federal Reserve System shall be authorized and empowered:

* * * * * * *

"(c) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: *Provided*, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified: *And provided further*, That when the reserve held against Federal Reserve notes falls below 25 per centum, the Board of Governors of the Federal Reserve System shall establish a graduated tax of not more than 1 per centum per annum upon such deficiency until the reserves fall to 20 per centum, and when said reserve falls below 20 per centum, a tax at the rate increasingly of not less than 1½ per centum per annum upon each 2½ per centum or fraction thereof that such reserve falls below 20 per centum. The tax shall be paid by the Reserve bank, but the Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Board of Governors of the Federal Reserve System."

This suspension authority, together with the penalty tax provisions, was part of the original Federal Reserve Act, as enacted in 1913, except that in the original act the reserve requirements were 40 percent against notes and 35 percent against deposits, and the higher tax rate became mandatory when a Reserve bank's reserve against notes fell below 32½ percent. The reduction from a 40-percent requirement against notes and 35 percent against deposits to 25 percent in each case was made by the act of June 12, 1945 (59 Stat. 237). Since you have expressed an interest in the origin of the gold cover requirement, I am attaching material on its legislative background and intent prepared by our staff.

The Board has exercised its authority under section 11(c) to suspend reserve requirements on three occasions. On November 7, 1919, the Board authorized Governor Harding to suspend reserve requirements of the Federal Reserve Bank of New York for a period not exceeding 10 days. On March 15, 1920, the Board suspended reserve requirements for all Federal Reserve banks for 10 days. On

March 3, 1933, the Board suspended reserve requirements for all Reserve banks for 30 days. None of these suspensions was renewed.

Penalty tax rates have been established at varying levels over the years under section 11(c). They have always been graduated according to the size of the deficiency, but three different beginning rates have been fixed. From the inception of the System until 1933, the rate on the first 5 percentage points of deficiency in reserve requirements was 1 percent per annum. On March 13, 1933, the Board cut the beginning rate to one-tenth of 1 percent per annum. This rate prevailed until June 30, 1945, when the Board adopted a higher rate schedule, following enactment of the legislation lowering reserve requirements to 25 percent. That schedule has continued unchanged up to the present time, as follows: one-half of 1 percent per annum when either the note of deposit reserve ratio falls to between 25 and 20 percent; 2 percent upon deficiencies below 20 percent down to 17½ percent, 3½ percent upon deficiencies below 17½ percent down to 15 percent, and an additional 1½ percent for each 2½ percent further decline in either reserve ratio below 15 percent.

In round numbers, the System's gold certificate reserves stand at $15 billion, to cover $18 billion in deposits and $31 billion in Federal Reserve notes. (A table is attached showing actual figures for October 30, 1963, but round figures will simplify the discussion at this point.) If there were a continued loss of gold reserves to the point where they were about to become insufficient to cover note and deposit liabilities (that is, if they fell from $15 to $12 billion), the Board could suspend the requirements to permit time for corrective adjustment. While the initial suspension is limited to 30 days, unlimited renewals are authorized, and, although no single renewal may be for more than 15 days, no overall limit is imposed on the duration of successive suspensions. If a reserve deficiency should prove unresponsive to corrective measures, the Board could, therefore, continue a suspension for as long as necessary to permit enactment of remedial legislation.

As long as a reserve deficiency were confined to what we may call the first "layer"—the reserves required against deposit liabilities—the only action required by law would be the imposition of a tax against the Federal Reserve banks. Under a longstanding interpretation of section 11(c), the tax need not be added to the banks' discount rates until the reserve deficiency penetrates into the second "layer"—the reserves required against Federal Reserve notes. For the System as a whole, therefore, reserves could fall from their present level of $15 billion to $8 billion before any increase in discount rates would be required by the act Under the present schedule of penalty rates, if reserves fell all the way through the first "layer" (down to $8 billion), the annual taxes on the reserve deficiency (using $18 billion as the figure for deposits) would be something under $300 million a year. Payment of these taxes would diminish net earnings of the Federal Reserve banks and reduce by an equal amount their payments to the Treasury as interest on Federal Reserve notes, which amounted to $800 million in 1962. It should be understood that the total payment to the Treasury would not change; it would simply be divided into two parts adding to the same total, one part labeled "tax on reserve deficiencies" and the other labeled "interest on Federal Reserve notes." In the example, the total payment would still be $800 million, but $300 million would be in the form of a tax and $500 million would represent interest on notes.

If reserves continued to fall, so that a deficiency occurred in the reserve against Federal Reserve notes, with a consequent additional penalty tax for that deficiency, the statute would require the Reserve banks to "add an amount equal to said tax" to the rates they charge on advances to borrowing member banks. While the statute is not at all clear on the mechanics of imposing this added charge, perhaps the most reasonable method would be to raise the discount rate by the same number of percentage points as the penalty tax rate on the note reserve deficiency. For example, if the gold certificate reserves fell to 20 percent of Federal Reserve notes—or to about $6 billion—the penalty tax under present rates for the note reserve deficiency would be one-half of 1 percent (or $10 million). Adding the penalty tax rate to the present discount rate of 3.5 percent would result in a discount rate of 4 percent. Again, it should be understood that the Board could establish a different penalty tax rate in this case; the statute simply requires that it be "not more than 1 per centum per annum." The satutory minimum penalty tax rate would come into effect only if reserves fell below this point.

It seems reasonable to conclude that if this country's gold losses should continue to the point where the Reserve banks were unable to comply with

the 25 percent statutory reserve requirement, there is ample authority under the present act to meet the situation without disrupting the economy of the international payments mechanism, and to provide time for Congress to consider legislative action.

In response to your question about the arguments for and against keeping the gold reserve requirement, I doubt that I can add anything more to the testimony your committee has already received. In my judgment, no change in the requirement should be undertaken at this time, because the risks of such an undertaking outweigh the benefits to be gained. The principal risk in such a move under current conditions is that the public might interpret it as a sign of weakness portending failure in the Government's efforts to maintain the value of the dollar. I see no need to run this risk, because the gold cover requirement does not pose any obstacle to the use of our gold reserves in defense of the dollar, and the best way to deal with worries on that score is to lay before the public a full explanation of what the statute requires and the procedures for meeting its requirements. I appreciate this opportunity to contribute to that end.

Sincerely yours,

WM. McC. MARTIN, Jr., *Chairman.*

ATTACHMENT A

Application of Federal Reserve gold certificate reserve requirements, Oct. 30, 1963

[Dollar amounts in millions]

1. Combined Federal Reserve deposit liabilities	$17,810
2. Combined Federal Reserve note liabilities	31,442
3. Total Federal Reserve liabilities subject to reserve requirements	49,252
4. Total Federal Reserve gold certificate reserve	15,310
5. Less 25 percent reserve requirement on Federal Reserve notes and deposits	12,313
6. Equals excess gold certificate reserves	2,997
7. Plus 25 percent requirement on Federal Reserve deposits (deficiencies in this requirement necessitate no discount rate increase)	4,453
8. Equals total gold certificate reserve releasable without mandatory discount rate increase	7,450
9. Plus difference between 25 and 20 percent requirement on Federal Reserve notes (deficiencies in this range require only a small discount rate increase)	1,572
10. Equals total gold certificate reserves releasable without substantial mandatory discount rate increase	9,022

ATTACHMENT B

LEGISLATIVE BACKGROUND AND INTENT OF GOLD RESERVE PROVISIONS OF FEDERAL RESERVE ACT

The House report on H.R. 7837, 63d Congress, the 1913 bill which became the Federal Reserve Act, contains the following statement regarding the purpose of imposing reserve requirements on the proposed central banks:

"In a general way the committee believes that requirement of a fixed reserve is not a wise or desirable thing as viewed in the light of scientific banking principle. It believes, however, that in a country accustomed to fixed reserve requirements the prescription of a minimum reserve may have a beneficial effect, * * *." [1]

[1] U.S. Congress, House, Committee on Banking and Currency, changes in the Banking and Currency System of the United States, Report No. 69, to accompany H.R. 7837, 63d Cong., 1st sess., 1913, p. 71.

Since the "real bills doctrine" formed the theoretical basis for the original Federal Reserve Act, the members of the House Banking and Currency Committee evidently believed that limiting central bank credit expansion to the discounting of eligible paper would provide a sufficient check on monetary expansion, and that imposition of gold reserve requirements would be inconsistent with the "real bills" principle. However, because the precedents of reserve requirements for national banks and for various foreign central banks suggested that there might be a problem of public confidence, the committee members were willing to recommend gold reserve requirements. Other legislators, and the majority of the National Monetary Commission, were strong supporters of the idea that the central bank's liabilities should be restrained by the level of gold reserves.

According to the House report on H.R. 7837, the Federal Reserve Board's power to suspend reserve requirements was based upon a similar provision in the National Bank Act of 1864.[2] Under this latter provision the Comptroller was required to notify a bank with a reserve deficiency to "make good" the deficiency. If after 30 days the deficiency still continued, the Comptroller could, with concurrence of the Secretary of the Treasury, appoint a receiver to wind up the business of the bank.

Section 22 of H.R. 7837 was taken almost word for word from this section of the National Bank Act. Hence, in this early version of the Federal Reserve bill the Board would apparently have been required to close a reserve deficient Reserve bank and appoint a receiver therefor if such bank should fail to make good its required reserve after receiving 30 days' notice from the Board to eliminate such reserve deficiency.

In later versions of the bill, the Board's power to close a Reserve bank was replaced with the mandatory requirement to impose a graduated tax on any bank with a reserve deficiency. Such a change would seem to shift the emphasis of adjustment from the mechanism of temporary suspension of requirements to the process of tax and discount rate increases and consequent restraint upon monetary expansion.

The provision of a penalty for reserve deficiencies appeared to be drawn from European central bank regulation, most specifically the German central bank.[3] Inclusion of a penalty is confirming evidence that the congressional authors of the act were not prepared to follow unequivocally the "real bills" doctrine with its attendant implications that Federal Reserve discounting of "real bills" would automatically provide the "right" amount of money. This conclusion is a logical consequence of the provision which requires a reserve deficient Reserve bank to respond to the penalty tax by raising the interest and discount rates which it receives on such "real bills." The Congress evidently envisioned that the tax-induced increases in discount rates would reduce Federal Reserve credit, which, in turn, would eliminate the reserve deficiency while reducing bank reserves and the money supply.

The language of the act as enacted could be interpreted as suggesting that the effects of the penalty were expected to apply to individual Reserve banks, encouraging asset transfers or liquidation of liabilities only by the particular Reserve bank affected. Study reveals, however, that penalty provisions were included in early versions of central bank bills, including the Aldrich bill which proposed one centralized monetary institution, and hence there are grounds for presuming that the deflationary consequences of the penalty tax were expected to be nationwide in scope.

Senator DIRKSEN. Well, Mr. Martin, if these bills are backed by gold, in proportion to these gold certificates that are issued, they do become a claim upon our gold reserves?

Mr. MARTIN. That is right.

Senator DIRKSEN. And it is at least that much of a draw upon the gold reserves?

Mr. MARTIN. That is correct.

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[2] Ibid., p. 46. See sec. 5191 of the Rev. Stat. for this provision in the National Bank Act of 1864.

[3] Owen, Robert L., "The Federal Reserve Act," New York, Century Co. (1919, pp. 12–14 and 19–24.

Senator DIRKSEN. And as I recall, that would need a coverage of about another $1 billion, and what we have stored at Fort Knox and what is available in the bank in New York I would say offhand is in the neighborhood of $15 billion—so that our reserve then has run down to about $4 billion?

Mr. MARTIN. Our free reserves are a little less than that, Senator, around $3 billion. So, we do have to watch our gold stock carefully and that is one of the reasons for the activity which the Federal is engaged in, in the interchanges of currencies that we make with foreign countries, and one of the reasons that the Treasury has issued this special type of bonds with denominations in foreign currency—both of these devices, and they are only devices, are means of financing claims against the dollar without resorting to gold.

Senator DIRKSEN. Is it proposed to replace all of those certificates with gold backed certificates?

Mr. MARTIN. Over a period of time, yes.

Senator DIRKSEN. And how long would that be?

Mr. MARTIN. Well, I think it might take as long as 10 years, because they will only come back gradually and——

Senator BENNETT. May I interject at this point? This depends on how free the Treasury is in selling bullion to the silver processors.

Mr. MARTIN. That is right.

Senator BENNETT. And they have sold 16 million ounces, as I remember it, since this started about 3 months ago, so it could be a period as short as several years. I am sure that they will stop selling bullion before that happens. They have about $1.6 billion ounces of silver valued at approximately $2.1 billion on hand, and they are faced with two demands, one for bullion for industry and the other for silver for coinage. Now that we are in this slot machine economy where we buy everything in automatic vendors, the demand for small silver coinage is much greater than it used to be. So it is not going to be too many years before we face the problem of, where are we going to get the silver?

Senator CARLSON. Are we exporting any of that silver or selling it?

Mr. MARTIN. I really don't know, Senator.

Senator BENNETT. I don't think there is any limitation. You can sell it through a silver factor, usually Handy & Harmon, a firm that specializes in silver, and I think they are free to sell their silver anywhere in the world.

Mr. MARTIN. I am sure that is true, Senator, but I don't know whether they are exporting. I think you would know better than I would, Senator.

Senator BENNETT. Well, I don't specifically know whether they are exporting, but they are free to export.

The CHAIRMAN. Mr. Martin, since we have mentioned the loss of gold, the high point of our gold supply was in 1949, $24,466 million. By mid-1963 it had gone down to $15,733 million, meaning that more than two-thirds of the so-called free gold has been lost. That is correct, isn't it?

NOTE.—$15,733 million is as of June 30, 1963. Current figure is $15,600 million.

Mr. MARTIN. That is correct, yes. We ended the war, Senator, with about $20.1 billion in gold. Then everyone was looking to us to sup-

ply goods and services and they used their gold in the 4 succeeding years to pay for these in part so that by the time you are talking about, our gold stock went up to this $24 billion-and-something.

The CHAIRMAN. Well, it has been referred to this morning. There has been some sentiment to make the $12 billion of gold backing our own currency so-called free gold, in order to comply with the choice that is given in our dealings in foreign countries of either gold or dollars. Would you care to express an opinion as to the wisdom of taking the $12 billion gold backing our own currency and making it so-called free gold?

Mr. MARTIN. Well, I do not know what the level of the gold reserves ought to be to maintain our currency. We had a 40-percent requirement from the time that the act was enacted until, under Senator Taft's leadership, it was reduced to 25 percent in 1946.

When I went into the Army in 1941, our gold reserve was roughly 91 percent, that was the ratio of gold to the deposits in the Reserve banks and Federal Reserve notes outstanding. When I came out of the Army in late 1945 that ratio was between 45 and 50 percent.

We are the only country in the world today with an important currency, and ours is a reserve currency, that has a specific requirement of this type. The only other two currencies that have it are the Swiss franc and the Belgian franc. I would not want to change at this juncture the gold reserve requirement. I think that it makes us face up to the discipline of gold. But I think the important thing to recognize is that our gold is there to use, and we should make it very clear to everyone that we intend to meet our contractual commitments to pay our bills. What the right amount of gold is or what it ought to be, I am not sure, but I would hate to see us reduce the statutory requirement under the pressure to avoid the discipline of the balance of payments.

The CHAIRMAN. Is it not true that we are the only nation in the world in the settlement of international accounts that gives, when there is a deficit, that gives a choice of either gold or dollars and gives that choice of gold at $35 an ounce, which is much less than the average cost of production of gold over the world?

Mr. MARTIN. I think that is true, but let us not forget that we are the strongest country financially in the world, without any question.

The CHAIRMAN. I don't question that, but——

Mr. MARTIN. And that is the reason why our Russian friends have been selling gold for dollars.

The CHAIRMAN. I think that it would be a catastrophe for the free world and would have very terrific consequences if we ever want off of this, reneged on the proposition of offering gold or dollars. But I do think, it would seem to me that to make this $12 billion that we have for backing our own currency, to make that free gold would be an admission of weakness which may have disasterous results, too. What we have got to do, is in some way to preserve what we have or, putting it the other way, to prevent the flight of gold, whereby we have already lost two-thirds of the free gold in the space of about—how many years?

Senator TALMADGE. Fourteen years.

The CHAIRMAN. Yes, 14 years. And I say, if we should release $12 billion of gold and put it in the free gold, wouldn't the other nations think that was a sign of weakness on our part?

Mr. MARTIN. I agree with you and that is why I think it would be a mistake to do it at this time. But I want to say that I don't think is anything sacred about this percentage and I think the time may well come with the expansion of world trade and the limited amount of gold that there is in the world, where we might want to do what was done in 1946, that is, change that statutory requirements.

The CHAIRMAN. The only thing it would be, would be an admission that we were unable to control the flow of gold, in these international settlements. And certainly perhaps we should not do this until we had exhausted the free gold before we transfer this $12 billion to the free gold until our present balance, which is less than $4 billion is exhausted.

Mr. MARTIN. Well, Senator I am not disagreeing with you, that is right. I am only pointing out that in 1946 we adjusted our statutory requirement and at that time I think it was a wise adjustment and the time may come again when we might want to make an adjustment.

The CHAIRMAN. I am not discussing this from the standpoint of our own currency, the amount of gold that is backing our own currency. I am discussing it from the standpoint of international confidence in the dollar. And as long as we are the only country that offers gold or dollars in settlement of deficit accounts, if we were then to draw on our free gold, put it in this other account, it would certainly be an indication that we were not able to control these deficit payments.

Mr. MARTIN. At the current juncture, there is no question about it.

The CHAIRMAN. And I think that it would be one of the most serious things that could happen, with all of its dangerous implications because it is our military strength plus confidence in the dollar that is holding the free world together— isn't that right?

Mr. MARTIN. The dollar is the leading reserve currency the world.

The CHAIRMAN. And isn't it true that if the foreign nations lost confidence in our dollar—they have claims against us now for about $18 billion?

Mr. MARTIN. Well, they do have enough claims against us so that if they do exercise them, why——

The CHAIRMAN. I mean, they could exercise them if they saw fit?

Mr. MARTIN. That is right.

The CHAIRMAN. And that would wipe out all of the gold, both the free gold and the $4 billion in gold dedicated to foreign exchange?

Mr. MARTIN. That is correct, but that is true of the banking system, too, you see. If everybody converted all of their deposits into money——

The CHAIRMAN. What has been done or can be done to reduce this outflow of gold?

Mr. MARTIN. Well, the President, in his balance-of-payments talk in July, which I thought was a good presentation of this problem, pointed out the fact that we can reduce or we were considering reducing the military expenditures abroad and military grants-in-aid abroad in particular. In our foreign aid program, we were tying in our activities so that only about 20 percent of it, I think, goes out in free dollars that can be spent any place in the world. In other words, they were getting only our own commodities and our own

goods and services. And the other thing that we did was to close the gap in interest rates between what they could get abroad and what they could get here. Those were the major items, although there were a lot of other subsidiary items some of which the Federal Reserve has done. The Federal Reserve has been engaged in these foreign exchange activities. For a long time, over a period of years, we had not been engaged in the foreign exchange market at all.

One of the interesting things there was that in New York there used to be a lot of dealers in foreign exchange but during the war period all of these people just dried up because you had all of these nonconvertible currencies and there wasn't anything in it for them.

But now we have got a new market in foreign exchange developing and the Federal Reserve has worked with our sister central banks around the world to make arrangements for interchanges of currencies which we call swaps, so that we can draw on them or they can draw on us when there are temporary movements of funds, and this conserves our gold. And the Treasury has supplemented this by offering foreign countries, the French, the Dutch, and others, when they had gold accumulations, and opportunity to invest them over here in securities denominated in their currencies, and this also helps to conserve our gold.

Now, all of these programs that could be carried further, I think we may need to do more before we get through. But we are on the right track under the present circumstances.

The CHAIRMAN. The deficit in the balance of international payments in 1958 was $3,529 million, and in 1959 we had lost $3,743 million, and in 1960 the loss was $3,881 million, and in 1961, $2,370 million, and in 1962, $2,186 million.

Mr. MARTIN. Correct.

The CHAIRMAN. Would you give any estimate of 1963?

Mr. MARTIN. For 1963?

The CHAIRMAN. Yes.

Mr. MARTIN. Do you know what it is today, Mr. Noyes? I don't have the figure in mind.

The CHAIRMAN. For the calendar year?

Mr. MARTIN. Well, we have done much better by these activities. Mr. Noyes tells me the loss for the first three quarters was only $422 million.

The CHAIRMAN. And that was done by various things, such as Germany paying back the debt to us sooner than it was due and things of that kind. I am speaking of the long run. What has been done to prevent this seepage of gold?

Mr. MARTIN. Well, all of these activities must be pursued further, and they all need to have a good look taken at them, all of these Government programs that call for spending our money abroad, and that is a continuing process and one that we must pursue vigorously and consistently.

The CHAIRMAN. Thank you.

Senator MORTON. Mr. Chairman, your figures were for the imbalance of payments, were they not?

The CHAIRMAN. Yes, but they had a direct bearing on the loss of gold, in other words, if you didn't have the imbalance of payments,

then we wouldn't suffer the loss of gold. I mean, the gold has gone down from the $24.46 billion down to this figure of $15,733 million, and two-thirds of our free gold has been lost.

Mr. MARTIN. Senator, from the period that you mentioned, we had $24.46 billion gold in 1949. Then, over the next years up to the time of the Suez crises in 1957 we had an adverse balance of payments on the average of $1,500 million each year, but three-quarters of that amount was taken in dollar claims against us which did not involve any loss of gold. Then the turn came in 1958, about the time of the Monetary Fund and Bank meeting in New Delhi, when confidence in the dollar began to weaken, and since then we have lost, as you have pointed out, a very substantial amount of gold, so we are now down to this $15.6 billion figure.

The CHAIRMAN. The chief deficit losses came about from maintaining our troops abroad and the foreign aid and the money spent by the tourists abroad and funds invested abroad. Well, thank you very much, Mr. Martin.

Senator DIRKSEN. Mr. Martin, one other question. If the Treasury carried on a very rigid bond sales campaign to fund this deficit, then in proportion to people being induced to buy Government bonds with the money saved by virtue of a tax reduction, to that extent the bill would become a little self-defeating, wouldn't it, because you would reduce by that amount what they would have normally spent for normal consumer wares and consumers durables.

Mr. MARTIN. I agree that you put your finger on the flow of funds that is involved here and I think any activities by the Treasury to sell long-term bonds would have to fit in with this flow of funds.

Senator DIRKSEN. And the question is, where does it fit in?

Mr. MARTIN. That is a difficult question to answer; it gets into a very difficult area.

Senator DIRKSEN. Mr. Chairman, after I queried the Secretary of the Treasury, when he was before the committee, he did send me some material on this whole question of financing the budget deficit and also an appendix which is entitled "Recent Treasury Financing Experience."

Mr. Chairman, I believe that it might well be made part of the record and, if there is no objection, I think I would like to submit it.

(The material referred to follows:)

RECENT TREASURY FINANCING EXPERIENCE

The experience of the past several years provides evidence of the ways in which the Treasury can finance a sizable deficit in periods of rising private credit demands without upsetting the money markets, without hampering business activity, and without creating or adding to potential inflationary pressures. The achievement is especially noteworthy since, throughout this period, the Treasury's task was further complicated by the necessity to bring U.S. short-term rates of interest up into closer alinement with those prevailing in important foreign money markets for balance-of-payments reasons.

Since December 1961, a period in which business activity and private credit demands have risen substantially, the Treasury has financed a deficit of approximately $13.8 billion ($7.2 billion in calendar 1962, and about $6.6 billion

in 1963). At the same time, the structure of the outstanding debt has been improved. This financing has been accomplished without placing the long-term credit markets under pressure. In fact, many long-term interest rates are lower today than they were 2 years ago, even though credit demands to support higher levels of residential building, consumer purchases of durable goods, and expansion in other areas of the economy moved sharply higher.

This stability in the long-term credit markets has been maintained despite the addition of some $18 billion to Treasury debt issues due after 5 years, of which $2½ billion was in issues over 20 years in maturity. The long-term credit market's smooth absorption of the heavy volume of issues was made possible in good part by the Treasury's technique of advance refunding in which investors are invited to exchange existing issues not yet due for longer term securities and by the use of a new auction technique for Treasury bonds, which lets market forces set the interest rate competitively. In addition, the increased flow of funds through savings institutions provided an ample supply of longer term credit for other borrowers even as the Treasury successfully lengthened its own debt structure.

The emphasis on placing issues due in 5 years or more through these techniques has reflected the Treasury's continuing interest in a sound debt structure. These techniques have been particularly important in the past 2 years because, for balance-of-payments reasons, the Treasury has necessarily concentrated the bulk of its new cash financing in the short-term area. This was done to help increase the level of short-term interest rates in this country to levels sufficient to meet the competition of interest rates abroad.

Since December 1961 short-term rates, as exemplified by the 3-month bill rate, have increased from 2.60 percent to their present level of 3.50 percent. This was accomplished by increasing the supply of regular Treasury bills by some $11 billion, an amount nearly equal to the increase in the debt during the same period of time. But this financing of Treasury's new cash needs through short-term securities has not been reflected in a deterioration in the maturity structure of the public debt or created excessive liquidity in our financial structure. To the contrary, the lengthening of other debt issues in refunding operations, most notably advance refundings, has more than compensated for the increased bill issues, and also has reduced the amount outstanding of short-term issues, other than regular Treasury bills. Thus, although $11 billion of new cash financing has been done in the shortest term Treasury issues, short-dated debt due within 1 year has increased by only $3.5 billion, or 4 percent during the past 2 years—a rate less than one-half that of the growth in the economy during the same period of time—while the average length of the marketable debt has been increased from 4 years and 7 months to 5 years and 2 months.

An equally important achievement in avoiding future inflationary pressures has been the placement of the debt in the hands of nonbank investors. The $7½ billion increase in the public debt during calendar year 1962 was financed outside the commercial banking system. Private nonbank investors and Government investment accounts absorbed $6.2 billion, while the Federal Reserve banks, in their normal function of supplying the reserves for needed bank credit, acquired $1.9 billion of the debt. The commercial banks actually decreased their holdings of Governments by $700 million, while at the same time extending a record volume of credit to the private sector of the economy.

The pattern was similar in the first 9 months of calendar year 1963. The debt increase of $3.3 billion was placed in noninflationary hands; private nonbank investors and Government investment accounts increased their holdings by $6 billion, and the Federal Reserve increased its holdings by $1.7 billion. In contrast, commercial bank holdings of Governments were decreased by $4.4 billion.

During this period, it seems clear that the Treasury has demonstrated its ability to finance substantial deficits in noninflationary fashion without hampering business activity, while paying due attention to international balance-of-payments considerations and the dangers of building excessive liquidity that could help fuel inflation at some future time. While the problems faced by the Treasury in the years ahead will no doubt differ in some respects, this experience strongly indicates that the Treasury can and will successfully meet the challenge of financing the deficits that will remain after the tax program becomes effective.

FINANCING THE BUDGET DEFICIT OVER THE NEXT FEW YEARS

The prime purpose of the tax program is to stimulate our economy to fuller use of its productive potential and to increase our growth rate both by adding to consumer demand and improving the climate for investment, costs cutting, and productive effort. In the process, the program will entail some transitional loss of revenue, adding limited amounts to the deficits in prospect for this year and next absent any tax cut— and thus, to our financing problem. It is important, however, that this loss of revenue and the size of the prospective deficits be kept in perspective. The overall magniture of the financing task will not be greater than we have faced in recent years. With the Federal deficit declining as expected (with balance restored by fiscal 1967 or 1968) any added financing pressures from other sectors due to an expanding economy should be absorbed without undue strain in the money and capital markets, as has been the case in the last 32 months, when deficits have been increasing.

THE FINANCING JOB IN PERSPECTIVE

We estimate that the initial effect of tax reduction will be to enlarge the projected Federal budget deficit for fiscal 1964 by only $1.8 billion, after taking account of the early effects of the program in enlarging the base of taxable incomes and profits, and by $3.5 billion in fiscal 1965, when the program will be in full effect. With firm restraint on growth in expenditures, sufficient revenues will be generated at the new rates in fiscal 1965 to hold the budget deficit below $9.2 billion, as President Kennedy had pledged.

As the economy more fully reflects the stimulus from the tax program in terms of higher taxable incomes and profits, there should be no net loss of revenues as a result of tax reduction. Indeed, if the tax cut is successful in propelling the economy to reasonably full employment as we expect, revenues would be larger than with the current tax structure and the rates of growth we have experienced since 1957. This should make it possible to restore budgetary balance by fiscal 1967 or, at the latest by fiscal 1968, consistent with meeting the most pressing needs of our growing population for Government services.[1]

Consequently, we should be able to look forward to a persistent decline in our deficits from the $9 billion now projected for this year to balance by fiscal 1967 or 1968, although the initial revenue losses from the full tax program will mean that any reduction in fiscal 1965 will be considerably smaller than in subsequent years. This pattern of declining deficits contrasts to an average deficit of $7.2 billion for the 3 fiscal years 1962–64.

As recent experience suggests, the financing of deficits of this magnitude is not unmanageable, even while private credit demands are growing—one reflection of the vast savings potential of our economy.[2] Moreover, unlike the circumstances of the past few years, the deficits will be declining (and then disappear entirely) as the economy reaches the point that the stimulus of tax reduction is likely to generate large competing private demands; as credit demands rise from one direction, they will slacken from another.

THE RELATION OF SAVINGS TO INVESTMENT

A successful tax program implies substantial stimulus to business fixed and inventory investment, to residential housing, and to purchases of consumer durables. In each case, these will, in turn, generate sizable financing needs—a source of potential pressure on interest rates. However, tax reduction itself, by adding to the cash flow of businesses and increasing consumer disposable income will permit a significant portion of these increased expenditures to be internally financed, moderating the potential market pressures. Liberalized depreciation guidelines and the investment tax credit enacted last year, for instance, are already adding almost $2.5 billion a year to internal business resources. The bill now under consideration in the Senate will add to the resources available to almost all businesses for financing their expansion in-

[1] This memorandum does not, of course, deal with the internal financing problems that would flow from an international emergency requiring an increase in defense spending to a sharply higher plateau.

[2] Our experience in financing the deficits during 1962 and 1963 is reviewed in the attached appendix.

ternally, and will very substantially supplement the cash flow of smaller businesses that tend to be less liquid today.

More important, the higher incomes and higher profits implicit in more rapid business expansion will bring in its wake both higher tax revenues and higher savings, providing additional funds to meet the needs of borrowers, both public and private. This does not imply that individuals will save more relative to income; in fact, aggregate personal savings should be expected to remain within a normal range of 6 to 8 percent of income. However, savings in the form of retained earnings may indeed rise more rapidly than sales during periods of particularly rapid growth—this would be a reflection of rapid growth, not an indication that the stimulus of tax reduction is ineffective.

THE BALANCING OF CREDIT DEMANDS AND SUPPLY

The past 2½ years provide an apt illustration of the manner in which the financial needs generated by economic expansion can be balanced by the vast savings potential of this country, even while governmental demands for credit are large, without bringing about sharp increases in interest rates. The bottom half of table I attached shows the components of gross national investment.[3] It will be noticed that there were sizable increases in all three of the major components of domestic private investment, and in foreign investment as well, between 1961 and the first half of 1963. Purchases of consumer durable goods rose from a rate of $43.6 to $50.6 billion, residential construction from $21 to $23.8 billion, and business investment in plant and equipment and inventories from $48 to $55 billion. At the same time, the cash deficits of Federal, State, and local governments remained sizable, varying within a range of roughly $8 to $10 billion.

Along with this increase in the economy's investment outlays, there was necessarily an expansion in overall national saving, as shown in the upper half of table I. Saving by consumers (and nonprofit organizations) did not change much in relation to after-tax income, but in absolute figures rose by about $9.5 billion as a result of expanded economic activity and rising incomes. Another $8.3 billion increase in saving was accounted for by rising depreciation allowances and the larger retained earnings of businesses, both corporate and noncorporate.

This balancing of investment and saving did not require an appreciable rise in long-term interest rates—in fact some key long-term rates, such as for mortgages, are well below levels reached in the 1960–61 recession. Moreover, the increase in investment was not stimulated by large monetary expansion—in fact, the money supply has tended to grow more slowly than the economy as a whole. To appreciate how this overall expansion in saving and investment came about without inflation, excessive increases in the money supply, or pressures on long-term interest rates, it is helpful to refer to table II, showing the way in which the enlarged credit demands were financed.

The top half of the table shows the various ways in which borrowers raised the funds necessary to support expanded purchases of consumer durable goods, productive plant and equipment, and inventories. The net increase in loans from banks and others more than doubled between 1961, and mid-1963; consumer credit alone more than tripled. During the same period there was a striking rise in funds raised through mortgages (chiefly for residential construction) from $18.6 to $26.2 billion, and State and local governments increased their debt more rapidly. At the same time, borrowing by the U.S. Government from the public remained large, and the average maturity of the Federal debt was substantially lengthened. Only corporations—relatively flush with cash inflow—were able to cut back on their bond and stock financing.

These added demands for credit—amounting to some $17 billion between 1961 and the rate for the first half of 1963—were not met by monetizing a large

[3] The presentation there is an adaptation of the Federal Reserve Board's flow of funds accounts, since these accounts can be integrated more easily with analysis of the financial aspects of the saving-investment process. The chief difference between table I and the consolidated saving-investment accounts published by the Department of Commerce as part of their national income and product data is the inclusion in table I of consumer purchases of durable goods as investment, and a corresponding allowance for depreciation of those assets as part of gross saving. This inclusion is desirable in this analysis since purchases of consumer durable give rise to financing demands.

amount of debt. It will be noticed that the increases in demand deposits and currency shown in the bottom half of table II were modest in amount and showed no marked upward trend; over the 2½-year period the money supply grew by less than 7 percent, while the economy grew by about twice as much. Instead, there was an enormous expansion in the flow of funds into time and savings accounts of banks and other financial institutions, supplemented by added purchases of securities by businesses and individuals. The funds accumulated by savings institutions were, in turn, committed for longer term investment. Consequently, as a result of these savings decisions and the resulting voluntary acquisition of longer term assets, it was possible for rising credit demands in both the private and public sectors of the economy to be absorbed in a noninflationary environment while overall growth continued.

PROSPECTS FOR THE FUTURE

The fact that supply and demand factors balanced out in the credit market during the past 2½ years of business expansion without upward pressures on long-term interest rates is not meant to imply that the pattern can be continued indefinitely. But this experience does suggest that the transitional loss of revenues as a result of tax reduction, and the stimulus to private credit demands, that the tax program will provide, will not bring in their wake problems different in kind—or much different in degree—from those we have successfully managed to resolve in the past.

This memorandum does not attempt to set out precise quantitative forecasts of the magnitude and direction of flows of credit and savings over the next few years. But, as indicated earlier, it does appear reasonable to conclude that, even with larger internal sources of funds, private credit demands will expand. However, it may take some time for this to become apparent, and by the time these private credit demands are expanding sharply, the Treasury's needs will be declining. Consequently, increases in total financing needs should be of moderate proportions, not widely out of line with our growing savings potential.

Unless the savings patterns of individuals and businesses are drastically changed—and there is no reason today to think they will—it is evident that the great bulk of the expanded demands for credit will be matched by a willingness of savers to commit funds for investment. In addition, it would be entirely appropriate, as the existing slack in the economy is eliminated, for the money supply to increase moderately in support of balanced growth, permitting an accompanying further expansion in bank credit.

The administration and the Federal Reserve have also recognized that it is essential, in this process, to avoid an excessive amount of liquidity, by means of uncontrolled increases in the money supply or otherwise, thus building an inflationary potential for the future. Given this firm objective, with its corollary that monetary policy must not be used simply for the purpose of supporting a given structure of interest rates, the precise balance of forces in the credit market that will emerge over time as the effects of the tax cut fully permeate the economy cannot be predicted with certainty. But, looked at in this perspective, it is quite true that the tax cut may be so successful in bringing the economy toward its productive potential, and in stimulating new demands for investment, that higher interest rates will be necessary to maintain a balance between available savings and investment demands. In that event, the Treasury would indeed find it necessary to pay higher interest costs. But at that time, too, the budget should be in or approaching balance, sharply reducing the requirements of the Treasury for new cash. And, because of the progress that has been made in achieving a more balanced debt structure in recent years, the refunding task also promises to be substantially lighter than has been the case in the past.

Consequently, the problems for the Treasury should not be disturbing. And, to the extent they exist, they will be a small price to pay for the kind of vigorously expanding economy that would be implied by pressure on the credit markets.

TABLE I.—*Overall supply of and demand for savings, 1961–63*

[In billions of dollars]

	1961	1962	1st half 1963 at annual rate
Gross supply of savings:			
Consumers and nonprofit institutions [1]	80.0	83.6	89.4
Corporate, nonfinancial business	32.1	36.6	38.3
Capital consumption allowances	26.1	30.1	31.3
Retained earnings	6.0	6.5	7.0
Other business	14.2	15.4	16.3
Gross demand for savings:			
Private:			
Consumer durable goods	43.6	48.2	50.6
Business investment [2]	47.9	54.9	55.0
Residential construction	21.0	23.2	23.8
Foreign: Net foreign investment [3]	2.0	.8	3.1
Government deficits: [4]			
Federal	5.5	4.7	5.4
State and local	4.7	3.8	3.0
Statistical discrepancy	1.5	3.0	3.1

[1] Includes capital consumption allowances on consumer durable goods.
[2] Gross private fixed investment plus inventory change less residential construction.
[3] Includes errors and omissions item in the balance of payments.
[4] Deficit computed on Federal Reserve flow of funds basis; differs from cash budgetary deficit mainly because of different treatment of employee life insurance and retirement programs and because acquisition of credit market instruments by Government is considered an investment by Government rather than an expenditure.

Source: Adapted with minor changes in terminology and presentation from Federal Reserve Bulletin, October 1963, pp. 1458, 1462, and 1465.

TABLE II.—*Funds raised and supplied in credit markets, 1961—1st half of 1963*

[Millions of dollars]

	1961	1962	1st half 1963 at annual rate
Funds raised by—			
Private loans	5.9	13.7	12.8
Consumer credit	1.7	5.8	5.7
Other loans	4.3	8.0	7.2
Securities and mortgages	31.0	34.5	36.7
State and local obligations	5.0	5.1	6.8
Corporate securities	7.3	4.8	3.7
Mortgages	18.6	24.8	26.2
U.S. Government [1]	7.5	7.6	10.8
Short-term securities	11.3	2.4	−.1
Long-term securities and other [2]	−3.8	5.2	10.9
Foreign borrowers	2.8	2.3	4.0
Total, funds raised	47.2	58.1	64.3
Funds supplied by—			
Demand deposits and currency	4.5	1.6	2.9
Time and savings accounts	20.0	28.3	29.9
Direct purchases of securities	3.6	6.7	7.6
U.S. Government securities	−1.1	2.4	5.0
Other securities and mortgages [3]	4.7	4.3	2.6
Private insurance and pension reserves	8.7	9.0	8.9
Change in U.S. Government cash balance and lending	3.1	4.5	6.9
Foreign funds	2.2	2.5	3.5
Other sources [4]	5.1	5.6	4.6
Total, funds supplied	47.2	58.1	64.3

[1] U.S. Government borrowing shown net of trust fund and certain other transactions, so does not equal change in public debt.
[2] Includes savings bonds and CCC-guaranteed bank loans.
[3] Less net borrowing by consumers to carry securities.
[4] Mainly consumer credit advanced by nonfinancial business, and financial sector net sources other than shown.

Source: Adapted with minor changes in terminology and presentation from Federal Reserve Bulletin, October 1963, p. 1462.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Martin, will you please explain to us how Government obligations create money and thereby inflation?

Mr. MARTIN. Well, Senator, banks have capital, surplus, undivided profits, and they have the power to write up assets from both sides of the ledger. This is only limited by the reserve requirements that are imposed upon them. They have to use certain standards of prudence, of course, with respect to making these loans, but the effective limit is that they have to maintain certain required reserves.

The difference between the private sector of the economy and the public sector of the economy, to my mind, always has been that where the banks write these assets up for, let us say, the XYZ corporation, they are making a judgment with respect to terms and conditions upon which the money will be repaid. And they have no facility to cover any losses that may be incurred. Thus, they have to stand or fall upon their judgment as to the ultimate success or failure of this enterprise.

When the Government borrows, they are always in the position that if the project does not pay out, if it does not return the revenues through the tax system, they can just create more money by printing.

Senator TALMADGE. Give us a specific example. What happens if the Federal Reserve buys $1 million of Government obligations?

Mr. MARTIN. Well then, the banking system has $1 million of reserves which can be——

Senator TALMADGE. That is the Federal Reserve?

Mr. MARTIN. The Federal Reserve creates reserves. We have reserve requirements on today of 16 percent for the reserve city banks and 12 percent for the country banks, therefore, they can expand loans and deposits, if they use all the reserves, roughly, we will say, six times the amount of the reserve dollars. That is why we call them high-powered dollars.

Senator TALMADGE. In other words, if the Federal Reserve bank has $1 million worth of Government bonds, it creates $6 million worth of credit?

Mr. MARTIN. That is right, theoretically. It may not create it, because it may not be put out——

Senator TALMADGE. Depending on the reserve, I take it——

Mr. MARTIN. That is right.

Senator TALMADGE. Now, would the same thing happen if a bank purchases those same obligations, say, a bank down in Atlanta?

Mr. MARTIN. Well, commercial bank credit is not high-powered credit. It would tend to have the same effect after it gets into the money stream, but it is not the central bank that is doing it and, therefore, it does not have the reserve creating effect that the central bank has with its purchases.

Senator TALMADGE. They would be limited, I presume, by State law?

Mr. MARTIN. That is right.

Senator TALMADGE. Whatever it was as far as the reserve required.

Mr. MARTIN. Right.

Senator TALMADGE. Then it is your opinion, is it, that in order to keep down inflation, from that standpoint, it would be very, very dangerous indeed for the Federal Reserve to make any purchases of Government obligations?

Mr. MARTIN. Well, Senator, this is the difficult area of judgment. We want to see some increase in the money supply, and I don't believe that we can put it precisely on a statistical basis. Some people say that it ought to be 3 percent a year, some people say that it ought to be 5 percent a year, some people think that it ought to be 1 percent a year, but it has to be in relation to the flow of funds by which—I mean, the active use of these funds. Over the last year, we had an increase of the money supply of better than 3 percent for the year as a whole, and if we add time deposits which can be included, in my judgment, in part at least in the money supply, that would bring it up to the neighborhood of about 7 percent.

It is the increase in the money supply in relation to the increase in goods and services that are available, that creates the price pressure. As long as there exists an adequate supply of goods and services, this problem does not arise, but this can be absorbed very quickly by additional purchasing power, and then when the prices begin to rise they rise awfully fast.

Senator TALMADGE. Of the more than $300 million outstanding in Government obligations, how much does the Federal Reserve hold?

Mr. MARTIN. We have about a little over 30.

Senator TALMADGE. A little better than $30 million?

Mr. MARTIN. Billion.

Senator TALMADGE. And that in turn generates about $200 billion worth of credit?

Mr. MARTIN. Something in that aggregate, that is correct. And this is the point, you see, a government certainly ought not to use this machinery to sell its bonds to itself. It can sell some percentage of them to itself, perhaps.

Senator TALMADGE. What, in your opinion, is the primary reason for the more than 50-percent erosion in the value of the dollar in the last 20 or 25 years?

Mr. MARTIN. Inflation. It has come about through overspending and undersaving, in the sense of the relation of these two to the——

Senator TALMADGE. Over spending by whom?

Mr. MARTIN. By Government and in some instances by private business and individuals. Now, this debt that we are talking about here, you frequently hear people say, "Why worry about this? We owe it to ourselves." That is not technically true, we owe it to each other, not to ourselves.

Senator TALMADGE. You don't quite buy that philosophy?

Mr. MARTIN. No, I don't.

Senator TALMADGE. And I might say that I don't buy that philosophy, either. Well, do you agree that as long as we have deficits we will continue to have inflation and further erosion of the dollar?

Mr. MARTIN. Well, not necessarily. You get into a certain amount of theorizing on all these things and we all have our points of view. I happen to believe that the flow of funds was such that inflation got ahead of us a number of years ago and we had to stop the expectation of inflation which was constantly with us if we didn't get this money stream back into its channels. And I think we were successful and I think that we have been able to finance the current deficit without creating inflation. In other words, the retained earnings and the depreciation allowances and the other savings in the economy have been such that the Federal Reserve has not had to go beyond a modest

increase in the money supply which would be not over and above what the economy could use without inflation.

Now, we may be reaching the limit of that. We may have come through this period, and I think we have done surprisingly well during the last year and a half. But I think that we just have got to recognzie that the time has come when we must not let this inflation get ahead of us again as it did in 1955.

Senator TALMADGE. Thank you, Mr. Martin. No further questions, Mr. Chairman.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Martin, without asking you to comment on any specific provisions of this tax bill, would you care to express an opinion on the advisability of enacting it, enacting legislation for a $11 billion tax reduction in the face of our present level of economy?

Mr. MARTIN. Well, Senator, I would put it this way. We have been talking about—and you gentlemen know this far better than I do—we have been talking about tax reduction, tax revision, tax reform, almost as long as I can remember being in Washington. And I think we have about reached the point where it would be desirable to see what will come out of this sort of thing.

I don't believe that we can go on indefinitely talking abcut these things. I think we all recognize that we are still living with wartime taxes in the economy and there are a lot of changes that are overdue. Where I come out is that there is a hazard, a real risk, whenever you engage in facing up to a deficit of this sort by trying to enlarge purchasing power at the consumer level and at the investment level.

Now, this is not very helpful, but I think that by and large, all things being considered, the risk is worth taking at this juncture. But the risk is a very real risk, and it may turn out to be adverse, and then you will have difficulty picking up the pieces.

Senator WILLIAMS. Then you would, as I understand it, with reference to this bill, feel that we should proceed to the enactment of this $11 billion tax cut, even though, as near as we can guess from the early predictions, next year's budget will be $3 or $4 billion higher than last year, so it will not be accompanied by any corresponding reduction in expenditures, and quite to the contrary it will be accompanied by an increase in expenditures, over the level of last year—and you think that we can handle that situation without endangering the stability of the dollar?

Mr. MARTIN. Well, I think it is going to be a very difficult problem and I think that we are going to have to put all of the pressure that we possibly can on reducing expenditures and financing it without resort to the banking system except for a very minimum amount.

Senator WILLIAMS. Well, of course, I agree with you fully on the point of reducing expenditures but in reality the situation is that we are going to increase expenditures next year, by all indications, by $3 or $4 billion over last year. So, I think that we have to weigh it in the light of that situation which is almost certain to develop, rather than what we hope will develop.

Now, as I understand it, one of the measures that you are using to control this threat of inflation is the interest rates, is that correct?

Mr. MARTIN. That is right.

Senator WILLIAMS. And the second step, or another step which you

took some time back was raising the margin requirements on securities. Is that a part of controlling——

Mr. MARTIN. Yes, that is correct.

Senator WILLIAMS. I noticed, and this was called to my attention more forcibly by what happened in the commodity markets recently in connection with salad oil transactions which I am sure you are familiar with, that episode—but am I correct in my understanding that as of the moment there is no control, no central authority at the governmental level where they can limit this kind of marketing in commodities?

Mr. MARTIN. That is my understanding, Senator.

Senator WILLIAMS. Margins in securities trading are regulated by your agency?

Mr. MARTIN. The Federal Reserve Board.

Senator WILLIAMS. Would you care to express an opinion at this time on the advisability of inaugurating similar provisions, where your agency or some agency should have the power to regulate the margin requirements on commodities as well?

Mr. MARTIN. I have no question in my mind, and I have no doubt and have not had for a good many years, that there should be some margin requirement for commodity trading. And I think that this recent incident is an example. What they should be or who should administer them, I am not qualified at the moment to say. But I think that this case that we are just going through is a who-done-it of the first order and it does not reflect credit on anybody, I think it is really too bad, really too bad, to find that some credit was extended without any margin requirements at all on some commodities which turned out to be nonexistent, if I read the papers correctly.

Senator WILLIAMS. Well, it does apparently point up the need, a glaring need for some measures being taken where we could prevent the recurrence of such an incident. Would you be willing to submit, not for this record, but would you submit some memorandum with your recommendations as to just what steps may be appropriately taken to safeguard against a recurrence of this situation?

Mr. MARTIN. I will be glad to try to go into it, Senator, and give you a report on it.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Do I understand correctly, Mr. Martin, that you believe the main justification for the tax cut would be the incentive that might be provided?

Mr. MARTIN. That is right.

Senator RIBICOFF. And you think that it might help unemployment?

Mr. MARTIN. Yes, I think it is the incentives that will help the unemployment situation, Senator. We have had a lot of discussion, as you know, about technological unemployment and about structural unemployment——

Senator RIBICOFF. Well, do you pay any attention to that?

Mr. MARTIN. Yes, I pay a lot of attention to that. I don't know what the answer to the unemployment problem is. It is a very difficult one. I have tended to believe that there is more in the structural area than is generally recognized. But I realize that we should do all that we can to create jobs. New jobs are created both on the finance side and the investment side. The creation of new jobs, it seems to me,

comes more through the investment side and incentives for investment, than the other side.

Senator RIBICOFF. How would this incentive take care of unemployment, the structural unemployment.

Mr. MARTIN. Well, it won't, but if we look at the history of automation, initially it looks like a very black picture as far as unemployment is concerned but ultimately you have more productivity and products are being produced at lower prices, thereby stimulating the demand, and we have had jobs ultimately develop which take up the slack.

Senator RIBICOFF. We have many people who say that there are more people unemployed in manufacturing industries today than we had a number of years ago with increased productivity——

Mr. MARTIN. There are a lot of things involved. And I do not deny that there may be some waiting period, that maybe automation is going faster than employment. But I would put it as a matter of faith, if I may put it that way, that I really have faith in the ability of our economy over a period of time to make these adjustments and create the additional jobs. Insofar as the point that I was making on the tax cut, it was that if people have more incentive to invest or to spend as a result of getting the additional resources in their hands, I think that perhaps we ought to encourage that line and not just rely solely on public works to create these jobs.

Senator RIBICOFF. Would you be good enough to give us generally the amount of the debt, the Federal and State and local debt, what is the approximate amount of that debt today?

Mr. MARTIN. Well, Senator, I am very poor at figures but I can guess——

Mr. NOYES. I don't believe I have that with me. We can get it for you.

Mr. MARTIN. I will get it and submit it to you, Senator. Well, we know that we are over $300 billion on our Federal——

Senator RIBICOFF. Well, that is on the Federal debt. Would you say that the private debt would be more than that?

Mr. MARTIN. Yes, it is.

Mr. NOYES. Considerably larger.

Mr. MARTIN. I would say nearly double.

(The following was later received for the record:)

Government and private debt in the United States

[Selected yearend dates, in billions of dollars]

	1946	1950	1956	1962
Total net debt	397.4	490.3	707.5	1,017.3
Total net Government debt	243.3	239.4	268.1	329.7
Federal Government and agency [1]	229.7	218.7	225.4	255.9
State and local governments	13.6	20.7	42.7	73.7
Total net private debt	154.1	250.9	439.4	687.6
Corporations	93.5	142.1	231.7	346.0
Individuals and noncorporate business	60.6	108.8	207.7	341.7

[1] Differs from debt subject to statutory debt limit. Includes debt of Federal agencies, but excludes Federal debt held by Government trust funds and other U.S. instrumentalities.

Source: Department of Commerce, Survey of Current Business.

Senator RIBICOFF. There is, of course, this theory and I would like to ask you about it, I am just curious, why is it proper to have private debt and not public debt?

Mr. MARTIN. Well, I don't think it is improper—do you?

Senator RIBICOFF. Well, let us say that American Telephone & Telegraph or General Motors or any such corporation wants to expand, they want to issue, for example, long-term bonds, because they have faith in the future of this country and the business that they are going to do.

Mr. MARTIN. Well, yes. Well, I would make this distinction that if we had a State enterprise, for example, if American telephones were owned by the State and there was this expansion in new equipment, it would be quite different from the other expenditures by the State, for what amounts to consumers goods activities, in the sense that these latter expenditures are not investments that will have a return. And this is where we get into difficulties, when we try to compare our budget to a foreign government. I am not arguing whether this is right or wrong, but we have more private enterprise than public enterprise, although we have the TVA and a lot of other things that have been successful, very successful, but we do not have such things as a national railway, for example, as they do in France. Where the railways are run by the State a bond issue to finance new investment in rolling stock or right-of-way is part of their Federal debt. They are not engaging in Government financing of consumer expenditures that do not have an immediate return, they are increasing their plant and equipment, just as our railroads would, and when they borrow for such purposes they expect a return on their investment.

Senator RIBICOFF. Well, let us take transportation as a good example, since you brought it up. This country needs transportation to survive and grow, is that correct?

Mr. MARTIN. That is right.

Senator RIBICOFF. And yet, there are certain sections in this country where mass transportation is running down.

Mr. MARTIN. Yes.

Senator RIBICOFF. And private capital is reluctant to go into that mass transportation.

Mr. MARTIN. Right.

Senator RIBICOFF. And if it came to a question of having no transportation or transportation run by the Government, would you be for the Government running the transportation system, if there was no private transportation that could be generated by private capital or private investment?

Mr. MARTIN. If that is what the people needed and wanted——

Senator RIBICOFF. And if that was so, then the Government might have to borrow that money?

Mr. MARTIN. That might be, but there they have the taxing authority to cover shortfall in reverse, which the American Telephone Co. does not have.

Senator RIBICOFF. All right, but basically doesn't American Telephone & Telegraph borrow money because of their faith in the growth of the United States?

Mr. MARTIN. Yes, of course, and they also relate it clearly to a profit. Your illustration was an enterprise where there would be a loss.

Senator RIBICOFF. But yet it would be a loss that you might want to bear because of the overall prospects for the future.

Mr. MARTIN. In which event they could probably do it through the banking channels.

Senator RIBICOFF. Here we are talking about doing it with a cutback, we are going to perhaps have to spend money without obtaining it. Let me give you another example.

We will be engaged very soon in a large civil rights battle and Congress will pass a civil rights measure in 3 or 4 months. Do you think that the passage of the civil rights bill will solve all the problems of the Negro in America?

Mr. MARTIN. It would certainly not.

Senator RIBICOFF. So, we are faced then with a problem involving about 20 million Negroes and about 20 million other Americans who economically are in the status of a Negro, or about 40 million in this country, taking the Appalachian area and certain other areas, with problems, in any event, of structural unemployment—now, what are you going to do with this?

Mr. MARTIN. Well, this is a part of the budgetary process——

Senator RIBICOFF. How about these 725,000 boys and girls between the ages of 16 and 20 who are out of work, about 20 percent of that age group? How are they going to be put to work if they are not trained for jobs, how are we going to train them to obtain money—train them without paying money, in other words, what I am trying to do is be realistic on this problem. And there are other problems—how are we going to solve these problems?

Mr. MARTIN. Well—I am very strong and have been right along for this retraining program and of course I am for spending money that way and I don't want people to suffer from unemployment, and as long as there is unemployment, I believe that there should be adequate insurance benefits and other devices of that sort. Now, of course, you know the difficulties of striking the proper balance, because if you give a man too much, he might not work at all, he may not have any incentive to work, and this is the problem that we are constantly facing in this area.

But by and large, we certainly should do all of these things that we are talking about and if we have to pay for them by taxing the body politic, we ought to do it. But we ought to be very careful in our program to encourage the profitmaking portion of the economy so that it can bear that cost and I believe that it can and will be able to do this. One of my frequent critics has referred to ours as an affluent society. If we have an affluent society, we ought to face up to it and make adequate provision for those who are unemployed through no fault of their own. But I must say that at the present time our level of unemployment is higher than we would like to see it.

I think we have done surprisingly well in some areas. We have been developing very rapidly in some fields and we should be very careful that we do not take actions that will undermine existing employment by putting the mechanism out of joint under the guise of taking care of people who are unemployed. This is the balance that we are trying to keep.

Senator RIBICOFF. I think you said a while ago to Senator Byrd that the United States and Switzerland and Belgium are the only countries that are on reserve currency.

Mr. MARTIN. I meant that have a statutory gold reserve requirement.

Senator RIBICOFF. Statutory requirement—how do the other nations keep their currencies stable? I mean, we do have other nations that are fairly stable. How do they operate?

Mr. MARTIN. In precisely the same way that we do. This problem to me—the simplest way I can put it is that it is evolutionary. Gold is something, as we all know, that was discovered which had intrinsic value and we began to use it as a means of exchange. And then we found that we did not need all gold, that we could superimpose upon it, so we had Government paper put on top of the gold and bank deposits on top of that. And the history of the 18th century was a succession of misuses of this pyramiding process, where we put more on top of this than could be handled—using this illustration of mine of the rubberband breaking—because unfit governments and unqualified bankers did not see things in there proper relation. But then we got into a period of stability from 1850 roughly into the 1900's. Then came the great depression and World War II.

World War II just tore us all apart, and the gold standard went down the road.

Now again in all countries, we are working toward stability and we are using gold, as the medium of international exchange. It is the international-exchange mechanism and we would not want it or care about it otherwise. Our people today have reasonable confidence in the stability and ability of our own Government——

Senator RIBICOFF. Confidence in the stability of our own Government in the face of this $12 billion in gold——

Mr. MARTIN (continuing). Confidence in the management of our finances. We cannot get away from the fact that today we can no longer be isolationists in this world. Our citizens are traveling abroad in increasing numbers. If we were limited strictly to our international income and had no way of acquiring that exchange except by our exports versus our imports our citizenry would get very alarmed and very upset very quickly. That is one of the things that I think we have to recognize in this whole balance-of-payments problem.

Senator RIBICOFF. Let us take Germany. Where is the confidence in German marks as against the confidence in American dollars—that is an internal problem.

Mr. MARTIN. Well, the difference between Germany and the United States today is due to the fact that they do not have a reserve currency.

Senator RIBICOFF. But their currency is stable?

Mr. MARTIN. Their currency is reasonably stable.

Senator RIBICOFF. Why is their currency stable, even though they do not have any reserve?

Mr. MARTIN. Because they manage their financial affairs well. They have come out from under a very disastrous inflation which struck home with every small man—and the reason we are against inflation is because it is not the rich man but the little man who suffers. Every man, woman, and child in Germany is against inflation, so it has been relatively easy for their Chancellor or Mr. Erhard to fight against inflation, and they handle their finances extremely well.

Also, they have not been under the pressures that we have been under, because their currency has not become a reserve currency for the world and they did not inherit the same responsibility for the markets of the world. In a sense they were benefited by the fact that we destroyed all of their plant and equipment. One of my German friends said to me, "You don't realize what an advantage this has been to us, because we put up all of our plant and equipment new."

Senator RIBICOFF. And with American money.

Mr. MARTIN. Yes, to some extent with American money.

Senator RIBICOFF. And now, you say that their currency is stable because they are managing it right. Are they doing something in managing their currency that we are not doing?

Mr. MARTIN. Well, they are struggling at the moment with inflation and they may find themselves in trouble before too long. And I would not say that the German mark is more stable than the U.S. dollar. But it has not had the pressure put on it from being a reserve currency that has been put on the dollar.

Senator RIBICOFF. Well, going a little further into what Senator Dirksen and Senator Byrd were talking about, what could the United States do to remove some of the pressures on the American dollar?

Mr. MARTIN. Well, I think that we have got to look at our commitments around the world and keep a very close eye as to what we can successfully maintain. I think that we need to get our foreign friends to carry some more of the burden than they are presently carrying, such as these activities in undeveloped areas. Now, this has been a long, hard process. It is easy for me to sit here and say that we should do more but the people in the State Department and the people in the foreign aid programs have their day-to-day responsibility and problems, the responsibilities for doing this.

And I think that the Marshall plan was one of the great achievements of the U.S. foreign policy, but I think that we have reached the point where, as we all know, excesses have occurred and I think that to a certain extent the United States has gotten into the position of being behind the eight ball, as some express it.

Now, I really think that if we take the President's statement of July 18 of this year and read it carefully, you will find that all the lines of attack that we ought to make are contained in that statement. I think it is a very good statement, although I don't see why we couldn't go further on some of the things than he went in that statement—it is really a pretty comprehensive paper.

And the thing that encouraged me the most about it is the fact that the President was alert to the problem, and was presenting the problem so carefully.

I will send you up a copy of this statement of July that will show you what I mean. I don't know whether we can reduce military commitments abroad, I know that Eisenhower has one view on this and others have other views on it, but I think that this is an area in which our expenditures are large and this is an area that should be examined. It seems to me that Secretary McNamara has been doing a splendid job of attacking this. And this is not in my field, of course, but this is certainly in the area, a line of attack that must be taken.

(The following was later received for the record:)

SPECIAL MESSAGE ON BALANCE OF PAYMENTS

To the Congress of the United States:

Soon after my inauguration, I reported to the Congress on the problems presented to this Nation by 3 successive years, beginning in the late 1950's, of mounting balance-of-payments deficits accompanied by large gold outflows; and I announced a program designed to restore both confidence in the dollar and eventual equilibrium in our international accounts. The challenge posed by those pressures was heightened at that time by the need to halt and reverse the spread of unemployment and revive our faltering economy. Rejecting a choice between two equally unpalatable alternatives—improved employment at home at the cost of a weaker dollar abroad or a stronger dollar at the cost of a weaker economy and nation—we sought a new course that would simultaneously increase our growth at home, reduce unemployment and strengthen the dollar by eliminating the deficit in our international payments. It is appropriate now—nearly 2½ years later—to look back on the problems faced, to review the progress made and to chart the course ahead.

There is much from which to take heart. Our economy has resumed its growth and unemployment has been reduced. The dollar remains strong, bulwarked by nearly 40 percent of the free world's monetary gold stock as well as by a newly constructed network of bilateral and multilateral financial arrangements. Our gold outflow has been halved. There are signs of longer run improvement in our world competitive position, as our prices and costs hold steady while others are rising. The deficit in our balance of payments has been reduced—from $3.9 billion in 1960 to $2.4 billion in 1961 and $2.2 billion in 1962.

Our basic strength, moreover, is vast, real, and enduring. Our payments billion. At the end of 1962, all of these assets exceeded our liabilities to for-liquid liabilities to foreigners, have consistently been equaled or exceeded by the growth of our long-term high-yielding foreign assets—assets which have been and will continue to be an increasing source of strength to our balance of payments. Today, Americans hold more than $60 billion of private investments abroad, and dollar loans repayable to the U.S. Government total over $11 billion. At the end of 1962, all of these assets exceeded our liabilities to foreigners by an estimated $27 billion. And they have shown an increasing strength over the years: our total income from these sources in 1959 was $3 billion; in 1962 it had risen to $4.3 billion; and we expect further substantial increases in the coming years.

These are all signs of progress. But unemployment is still too high; our growth rate is still too low; and it is now clear that, despite the favorable forces at work over the long run, more remains to be done today to eliminate the continuing payments deficit.

A significant portion of our progress so far has been due to special agreements with friendly foreign countries—for debt prepayments, advance payments for military equipment, and U.S. borrowings abroad. While similar arrangements may once again prove capable of covering a substantial amount of the gross deficit in 1963, such special transactions cannot be relied upon for the indefinite future. Moreover, while our commercial trade balance and Government expenditures overseas have shown modest improvement, capital outflows, both short- and long-term, has increased.

Although there is urgent need for further effort I want to make it clear that, in solving its international payments problem, this Nation will continue to adhere to its historic advocacy of freer trade and capital movements, and that it will continue to honor its obligation to carry a fair share of the defense and development of the free world. At the same time, we shall continue policies designed to reduce unemployment and stimulate growth here at home—for the well-being of all free peoples is inextricably entwined with the progress achieved by our own people. I want to make it equally clear that this Nation will maintain the dollar as good as gold, freely interchangeable with gold at $35 an ounce, the foundation-stone of the free world's trade and payments system.

But continued confidence at home and cooperation abroad require further administrative and legislative inroads into the hard core of our continuing payments deficit—augmenting our long-range efforts to improve our economic performance over a period of years in order to achieve both external balance and internal expansion—stepping up our shorter run efforts to reduce our balance-of-payments deficits while the long-range forces are at work—and adding to our stockpile of

arrangements designed to finance our deficits during our return to equilibrium in a way that assures the continued smooth functioning of the world's monetary and trade systems.

Before turning to the specific measures in the latter two categories, I must emphasize once again the necessity of improving this Nation's overall long-range economic performance—including increased investment and modernization for greater productivity and profits, continued cost and price stability and full employment and faster growth. This is the key to improving our international competitiveness, increasing our trade surpluses and reducing our capital outflows.

That is why early enactment of the comprehensive tax reduction and revision program previously submitted is the single most important step that can be taken to achieve balance abroad as well as growth here at home. The increased investment incentives and purchasing power these personal and corporate tax reductions would create—combined with last year's actions giving special credits for new investment and more favorable depreciation treatment—will promote more employment, production, sales, and investment, particularly when accompanied by the continued ample availability of credit and reasonable long-term rates of interest. A prosperous, high-investment economy brings with it the rapid gains in productivity and efficiency which are so essential to the improvement of our competitive position abroad.

To gain new markets abroad and retain the gains of new growth and efficiency here at home, we must continue the price-cost stability of recent years, limiting wage and profit increases to their fair share of our improving productivity. That is why we have, for 2 years, been urging business and labor to recognize and use reasonable wage-price guideposts for resolving the issues of collective bargaining. Our success in holding down our price level relative to that of our major competitors is a powerful force working to restore our payments balance over the longer run. This fact should not be obscured by current short-run developments.

While these long-range forces are taking effect, a series of more immediate and specialized efforts are needed to reduce the deficit in our international transactions and defend our gold reserves:

1. Export expansion: Our commercial sales of goods and services to foreign countries in 1962 exceeded our purchases by $4.3 billion, and they are continuing at about the same rate this year. This is our greatest strength, but it is not enough. Our exports of goods have risen only moderately over the past 3 years, and have not kept pace with the rapid rise of imports which has accompanied our domestic expansion. As a result, rather than furnishing increased support for our other transactions, 1962 saw a decline in our commercial trade surplus.

The primary long-term means for correcting this situation is implementation of the Trade Expansion Act of 1962. The special representative for trade negotiations is preparing to use, to the fullest extent, the authority given to me by the act, in an across-the-board drive for lower tariffs and against other barriers to trade. This should open new markets and widen existing markets for American exports.

As mentioned above, our whole long-range domestic program—including increased investment, improved productivity, and wage-price stability—is designed to better the competitive position of our products, both at home and abroad. Continued price stability at home, contrasted with the upward trend in prices abroad, will create an increasingly favorable climate for American exports; and this administration is concentrating on six immediate measures to help American businessmen take advantage of our export potential.

First, the Export-Import Bank has created a wholly new program of export financing which now provides U.S. business with credit facilities equal to any in the world. The major element in this new program is the guarantee of short- and medium-term export credits by the Foreign Credit Insurance Association, composed of more than 70 private insurance companies in conjunction with the Export-Import Bank. I urge the Congress to act promptly to restore the Bank to full operating efficiency by renewing its charter and authorizing adequate financing.

Second, the Departments of State and Commerce have strengthened and expanded efforts overseas to probe for new markets and promote the sale and distribution of American products.

Third, the Department of Commerce has developed a broad program of education and assistance to present and potential American exporters. I have requested a relatively small amount of additional funds to strengthen the

Department's efforts to stimulate our exports. These funds, amounting to $6 million, were not approved by the House of Representatives. It is essential, if we are to increase our trade surplus, that they be included in the final appropriation bill. This modest sum would pay for itself many times over in increased exports, lower payments deficits, and protection for our gold reserves.

Fourth, the Department of Agriculture announced last March a new auction program for direct sales of cotton abroad. It is expected that this new technique will insure competitive pricing for our cotton in export markets and will increase exports by as much as $100 million over last year's levels.

Fifth, present ocean freight rates discourage our exports as compared to imports. The freight charges on Atlantic crossings are far higher for eastbound freight than for comparable items bound for our shores. A similar situation prevails on other trade routes. While these substantial differentials may have been acceptable in the immediate postwar period of the dollar shortage when Europe was struggling to get on its feet, their magnitude is clearly unjustified today. Accordingly, I have directed the Secretary of Commerce to take corrective action through the Maritime Administration; and I am urging the Federal Maritime Commission in its role as an independent regulatory agency to question those specific export rates which appear unduly high. Should legislation prove necessary, it will be sought.

Sixth, in order to give further momentum to the expansion of our export performance, I will convene a White House Conference on Export Expansion on September 17 and 18, to alert American firms, whether or not they are now exporting, to the opportunities and rewards of initiating or expanding export efforts. We shall use this opportunity to emphasize to American businessmen that vigorous action to increase their exports would serve their own private interests as well as the national interest.

2. Tourism: Another element that requires attention in our commercial transactions is the increase in our unfavorable net tourist balance. With increasing prosperity encouraging American travel abroad, total tourist spending in foreign countries rose another 10 percent last year, to nearly $2½ billion. This was partially offset by increased foreign tourist expenditures in the United States, but the net result was an outflow of $1.4 billion, or two-thirds of last year's overall balance-of-payments deficit. This year, the cost is estimated to be still greater. That is why we have had to limit the duty-free exemption for returning tourists to $100 per person. Last year this measure achieved a saving of more than $100 million, and I am gratified that Congress has extended the limitation for another 2 years. We have also sought, through establishment of the U.S. Travel Service, to increase our income from visitors coming to our country. To further that effort, I strongly recommend that Congress approve the full amount of the appropriation requested for the U.S. Travel Service.

In addition, in cooperation with the appropriate Government agencies, I am asking the domestic travel and tourism industry to launch a more unified drive to encourage Americans to learn more about their own country and the glory of their heritage. A "See America Now" program, to be in full operation by the spring of 1964, will make the most of our magnificent resources, and make travel at home a more appealing alternative to travel abroad.

3. Federal expenditures abroad: Federal expenditures abroad go largely for defense and aid. These represent the obligations which flow from our position of world leadership and unrivaled economic strength. With the recovery of other economically advanced nations, particularly our allies in Western Europe, we have made vigorous and increasingly successful efforts to work out with them a better sharing of our common responsibilities. These efforts—combined with rigorous scrutiny of offshore expenditures—have enabled us, in spite of mounting worldwide requirements and costs, to reduce the overall total of our own oversea expenditures while we increase the security of the free world and maintain a high level of assistance to developing countries.

A continual process of modernizing our Armed Forces and increasing efficiency, resulting in heightened defense effectiveness, is reducing the requirements for oversea dollars expenditures. At the same time, by tying our aid more effectively to domestic procurement and cutting civilian expenditures sharply, we should be able to achieve further savings. In fact, by January 1965, these processes should result in a reduction of the rate of our Federal oversea dollar expenditures by approximately $1 billion from that of 1962.

(*A*) *Military expenditures*

The Defense Department has, since the beginning of this administration, been making vigorous efforts to restrain oversea expenditures, without reducing military effectiveness.

Thus, despite the Berlin buildup of 1961 and rising costs overseas, gross expenditures abroad by the Defense Department have been held below 1960 levels. As a result of the desire of our allies to acquire from us modern military equipment, which they need to strengthen free world defenses, at lower cost than they could produce the equipment themselves, substantial offsets to these expenditures have also been achieved, so that our net outlays abroad for defense have declined from $2.7 billion in 1960 to $1.9 billion in 1962.

In line with these continuing efforts, the Secretary of Defense has informed me that the annual rate of expenditures abroad by the Department of Defense will be reduced—by measures to be put into effect before the end of calendar year 1964—by more than $300 million from the 1962 level. At the same time, the Department of Defense will continue to seek arrangements with major allied countries to increase their military procurement from the United States so as to reduce the net outflow still further. The Secretary has further assured me that this reduction will be accomplished without any reduction in the effectiveness of our military posture, and with no impairment in our ability to meet our commitments to our allies in all parts of the world.

In addition to direct expenditures by the Defense Department, our defense expenditures abroad have, for many years, been increased by the cost of programs for the acquisition of strategic materials from foreign sources. The cost of these programs is now steadily declining, since they have largely fulfilled their purpose and are no longer needed. Within 2 years they will be reduced by over $200 million as compared to 1962, insuring a total reduction in defense dollar expenditures well in excess of $500 million.

(*B*) *Agency for International Development*

During 1960, only about one-third of AID program expenditures were in the form of U.S. goods and services. Last year, that proportion had risen to about 50 percent. But during the fiscal year which ended last month, fully 80 percent of AID's commitments were tied to the export of U.S. goods and services. The balance was virtually all committed for purchases in the less-developed countries rather than in the developed nations where the payments surpluses exist which give rise to our deficit. During fiscal year 1964, for which funds are now being considered by the Congress, AID commitments tied to U.S. exports will rise beyond 80 percent of the total. I have directed the Administrator of AID to continue and intensify this policy so that AID expenditures entering our balance of payments in fiscal year 1965 may be further reduced by about $500 million as compared to fiscal year 1961, from about $1 billion to not over $500 million, the lowest practicable minimum.

(*C*) *Other departments and agencies*

The oversea disbursements of all other departments of Government have also been brought under special review and control by the Director of the Bureau of the Budget. Total Federal expenditures abroad (excluding Defense, AID, Treasury payments on foreign-held debt and Federal pension payments) coming within the scope of this review now amount to approximately $600 million per year. The Director of the Budget has assured me that vigorous screening of expenditures abroad by these other Federal departments and agencies will achieve further substantial balance-of-payments savings. These savings, together with those which may be expected from revisions of programs under the Agricultural Trade Development and Assistance Act, should amount to some $100 million a year. This includes my request to the Congress to enact legislation permitting freer use of our present holdings of the currencies of a number of other countries.

4. Short-term capital flows: By skillful use of the tools of debt management and monetary policy, the Treasury Department and the Federal Reserve System have substantially reduced the outflow of short-term capital through a series of carefully managed increases in short-term money rates, while maintaining ample credit availability and keeping both long-term rates and bank loan rates low and, in many cases, declining. Experience in the recovery underway over the past 2½ years provides a solid basis for expecting that a determined effort can succeed in keeping long-term investment and mortgage money plentiful and cheap while boosting short-term interest rates. From February 1961 through July 12,

1963, the rate on newly issued 3-month Treasury bills rose 76 basis points, while the rise in long-term Treasury bond yields was held to only 22 basis points and the yields on high-grade corporate bonds and mortgages actually declined.

However, the recorded outflows of short-term funds—together with unrecorded net outflows, a large portion of which undoubtedly represent short-term capital movements—still amounted to approximately $1.6 billion in 1962 and have continued on a substantial scale so far this year. A sizable reduction in this drain would do much to strengthen our overall balance of payments. It is for this reason that the Federal Reserve has decided to increase the rediscount rate from 3 to 3½ percent. At the same time, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation have raised the interest-rate ceilings on time deposits payable in 90 days to 1 year, in order to enable our banks to compete more effectively with those abroad and thus attract funds that might otherwise leave the country.

While none of us welcomes higher interest rates at a time when our economy is operating below capacity, an increase in short-term rates—at a time when liquid savings are growing rapidly, and when there are no accompanying restrictions on credit availability nor parallel increases in the interest rates on bank loans, home mortgages or other long-term obligations—should have little, if any, adverse effect on our economy. The unprecedented flow of liquid savings should largely insulate the longer term markets from the effect of higher short-term rates. I have been assured by both Treasury and Federal Reserve officials that they intend to do everything possible through debt management policy and open-market operations to avoid any reduction in domestic credit availability and any upward pressure on long-term interest rates while the economy operates below capacity without inflation. Other agencies of the Federal Government will work to maintain continued ready availability of private mortgage loans at stable interest rates. Nevertheless, the situation lends increased urgency to the fiscal stimulus that would be provided by the prompt enactment of the substantial tax reductions I have recommended.

5. Long-term capital outflows consisting of direct investment in productive plant abroad appear to have leveled off in recent years, whereas portfolio investments in the form of long-term loans or securties purchases have been rising rapidly. While our long-range program should increase the attractiveness of domestic investment and further reduce the outflow of direct investment, the rising outflow of long-term capital for portfolio investment abroad shows no sign of abating. It is up from $850 million in 1960 to $1.2 billion in 1962, and so far this year is running at an annual rate of well over $1.5 billion.

In view of the continued existence of direct controls and inadequate capital market mechanisms in many foreign countries, and the wide differential between the long-term rates of interest in the larger industrial countries and the United States, there appear to be only three possible solutions to this problem, two of which are unacceptable under present circumstances:

A substantial increase in our whole long-term interest rate structure would throw our economy into reverse, increase unemployment, and substantially reduce our import requirements, thereby damaging the economy of every free nation;

The initiation of direct capital controls, which are in use in most countries, is inappropriate to our circumstances. It is contrary to our basic precept of free markets. We cannot take this route.

A third alternative—the one which I recommend—would stem the flood of foreign security sales in our markets and still be fully consistent with both economic growth and free capital movements. I urge the enactment by the Congress of an interest equalization tax, which would, in effect, increase by approximately 1 percent the interest cost to foreigners of obtaining capital in this country, and thus help equalize interest rate patterns for longer term financing in the United States and abroad. The rate of tax should be graduated from 2.75 percent to 15 percent of the value of debt obligations, according to the remaining maturity of the obligation, and should be 15 percent in the case of equity securities. This tax should remain in effect through 1965 when improvements in both our balance of payments and in the operation of foreign capital markets are expected to permit its abandonment.

Under this alternative, the allocation of savings for investment in securities will continue to be the result of decisions based on market prices. There will be no limitations on the marketing of foreign issues and no governmental

screening of borrowers. Reliance will be placed on price alone to effect an overall reduction in the outflow of American funds for stocks, bonds, and long-term loans, both new or outstanding, whether publicly marketed or privately placed.

The tax would not apply to direct investment. It would not apply to securities or loans that mature in less than 3 years. Nor would it apply to the loans of commercial banks. These exemptions will assure that export credit will remain fully available. Furthermore, purchases of the securities of less developed countries or of companies operating primarily in such countries will not be taxed.

Nor will the tax apply to transactions in foreign securities already owned by Americans, or to the purchase of securities by foreigners. Underwriters and dealers would be exempted from the tax on stock or securities resold to foreigners as part of the distribution of a new issue. But all Americans who purchase new or outstanding foreign securities from foreign issuers or owners would be subject to this tax. In order to avoid unfair burdens on transactions which are nearly complete, the tax should not apply to offerings of securities for which active registration statements are now on file with the Securities and Exchange Commission. Purchase commitments which have already been made should also not be affected.

The Secretary of the Treasury is submitting the details of this proposal to the Congress; and I have been assured that the House Ways and Means Committee will be prepared to give high priority to this proposal after action has been taken with respect to the overall program of tax reduction and reform now before it. Since the effectiveness of this tax requires its immediate application, I am asking Congress to make the legislation effective from the date of this message. The Internal Revenue Service will promptly make available all instructions necessary for interium fulfillment of the provisions of this recommendation, pending the enactment of legislation by the Congress.

6. Investment by foreign savers in the securities of U.S. private companies has fallen rapidly to less than $150 million in 1962. The better climate for investment that will flow from enactment of the program for tax reduction and reform now before the Congress will do much to improve this situation but a direct-action program is also needed to promote oversea sales of securities of U.S. companies. Such a program should also be designed to increase foreign participation in the financing of new or expanded operations on the part of U.S. companies operating abroad.

To meet these two facets of a single problem, a new and positive program should be directed to the following areas of effort:

(*a*) The identification and critical appraisal of the legal, administrative. and institutional restrictions remaining in the capital markets of other industrial nations of the free world which prevent the purchase of American securities and hamper U.S. companies in financing their operations abroad from non-U.S. sources;

(*b*) A review of U.S. Government and private activities which adversely affect foreign purchase of the securities of U.S. private companies; and

(*c*) A broad and intensive effort by the U.S. financial community to market securities of U.S. private companies to foreign investors, and to increase the availability of foreign financing for U.S. business operating abroad.

Such a program will necessarily involve a pooling of the know-how and efforts of the Government and the financial community. I have asked the Treasury Department, in consultation with the State Department, to develop an organization plan and program.

The increased freedom of capital movement and increased participation by foreign citizens and financial institutions in the ownership and financing of American business, toward which these efforts are directed, will serve to strengthen the economic and political ties of the free world as well as its monetary system. Securities of U.S. private firms could be and should be one of our best selling exports. An increasing foreign investment in these securities will encourage a more balanced two-way capital traffic between the United States and other capital markets and minimize the impact of net long-term capital outflows from the United States on our balance of payments.

7. Special Government transactions covered $1.4 billion of our deficit in 1962. These included prepayment of debt by foreign countries, advance payments on military purchases here, and the issuance by the Treasury of medium-

term securities to foreign official holders of dollars. Further debt prepayment is expected in 1963—France has just announced a prepayment of $160 million—but it is clear that these are temporary gains which cannot be repeated for very long. Nor is it likely that advance payments on military purchases will again be large, as the pace of deliveries against purchases is now rising.

Therefore, as our continuing balance-of-payments deficit leads to accruals of dollars by foreign central banks, exceeding the size of the dollar balances which they normally carry, it has been particularly helpful that a number of foreign governments and central banks have begun purchasing a new type of non-marketable medium-term Treasury security, denominated either in dollars or in their own currencies, as a convenient alternative to the purchase of gold. Some $610 million of such securities have been newly issued thus far in 1963.

Further debt prepayments and further sales of these securities during the remainder of this year will reflect the unprecedented degree of cooperation now prevailing in international finance and the growing recognition that correction of payments imbalances is a responsibility of the surplus as well as the deficit countries. In this spirit we shall also continue to press for a fuller and fairer sharing of the burdens of defense and aid and for the reduction or elimination of the trade barriers which impede our exports.

8. Gold sales and increased dollar holdings serve to finance what remains of our deficit after special governmental transactions. In 1962, this deficit amounted to approximately $2.2 billion. It was financed by the sale of $890 million in gold and $17 million of our holdings of foreign exchange as well a by an increase in foreign holdings of dollars and U.S. Government securities amounting to $653 million, and an increase of $626 million in the holdings of dollars by the International Monetary Fund.

The total outflow of gold for the 2 years 1961 and 1962 combined only slightly exceeded the outflow in the single year 1960; and the outflow in 1963 is running at a rate well below last year. Since the rise in short-term interest rates resulting from the recent action of the Federal Reserve will make it considerably more attractive for foreigners to hold their assets in dollars, including short term U.S. Government securities, prospects are improved that increased foreign holdings of these assets instead of gold will finance a still larger share of our deficit.

9. The International Monetary Fund, however, presents a different situation. Last year the Fund's dollar holdings increased as other countries paid off their debts in dollars and concentrated new borrowings in other convertible currencies to the extent practicable. But the Fund's rules provide that, except in the case of a drawing, that is, a borrowing, it cannot hold more of any currency than was paid in at the time of original subscription (in effect, 75 percent); and the Fund's holdings of dollars have now nearly reached that level.

To meet this situation the United States has requested and the Executive Board of the IMF has approved a $500 million standby arrangement which authorizes us to draw on the Fund from time to time during the coming year. It is our intention to utilize this authority for the purpose of facilitating repayments which are expected to total about $500 million during the course of the next 12 months. When a country desires to repay the Fund, we will draw convertible foreign currencies from the Fund, paying for them with dollars. The country making the repayment will use its own dollars to buy these foreign currencies from us in order to repay the Fund. All transfers will take place at par. Thus the Fund wil continue to finance a portion of our deficit by increasing its holdings of dollars and its various debtors will continue to have a simple and costless method by which they can redeem their obligations to the Fund. The alternative under present circumstances, now that they cannot pay off directly in dollars, would have been either to buy gold from the United States with which to repay the Fund, or to purchase other convertible currencies in the market with their dollars at extra cost and inconvenience.

Drawings by the United States under this new arrangement will be repayable in 3 years, with a 2-year extension available if needed. No interest will be payable, but the drawings will be subject to a one-time service charge of one-half of 1 percent.

10. Evolution of the international monetary system: During the past 2 years great progress has been made in strengthening the basic fabric of the international monetary system upon which the whole free world depends. Far closer cooperation among the central banks of the leading industrial countries has been achieved. Reciprocal credit arrangements have been established to meet in-

stantly any disruptive disturbance to international payments, arrangements which successfully contained the monetary repercussions of the Berlin crisis in 1961, the heavy pressure on the Canadian dollar in the spring of 1962, the Cuban crisis last autumn, the reaction that followed the exclusion of the United Kingdom from the Common Market, and a number of less striking events that might, in other years, have set off dangerous rounds of currency speculation. An informal but highly effective operating relationship has grown up among a number of the same countries with respect to the London gold market, ruling out for the future any repetition of the alarming rise in the price of gold which created such uncertainty in October 1960. Finally, 10 of the leading industrial countries have established a $6 billion facility for providing supplemental resources to the International Monetary Fund, which will be available in the event of any threat to the stability of the international monetary system.

The net result has been to provide strong defenses against successful raids on a major currency. Our efforts to strengthen these defenses will continue. While this process is taking place, the United States will continue to study and discuss with other countries measures which might be taken for a further strengthening of the international monetary system over the longer run. The U.S. interest in the continuing evolution of the system inaugurated at the time of Bretton Woods is not a result of our current payments deficits; rather it reflects our concern that adequate provision be made for the growth of international liquidity to finance expanding world trade over the years ahead. Indeed, one of the reasons that new sources of liquidity may well be needed is that, as we close our payments gap, we will cut down our provision of dollars to the rest of the world.

As yet, this Government is not prepared to recommend any specific prescription for long-term improvement of the international monetary system. But we are studying the matter closely; we shall be discussing possible improvements with our friends abroad; and our minds will be open to their initiatives. We share their view that the problem of improving the payments mechanism is one that demands careful joint deliberation. At the same time, we do not pretend that talk of long-range reform of the system is any substitute for the actions that we ourselves must take now.

THE PROMISE OF THE FUTURE

Full implementation of the program of action I have outlined today should lead to substantial improvement in our international payments. The rate of Government expenditures abroad will drop by $900 million over the next 18 months, and the combined effect of the increase in short-term interest rates and the interest equalization tax should equal, and more probably exceed, this figure. Gains of this magnitude, approximately $2 billion, will give us the time our basic long-term program needs to improve our international competitive position, and increase the attraction for investment in the United States.

These two objectives must be the basis of any permanent closing of the payments gap, and this program will achieve them without threatening our growth at home. It will also do so without compromising our adherence to the principles of freer trade and free movements of capital. It will, in fact, help prevent pressures for more restrictive measures. In short, while we must intensify our efforts, we can do so with full confidence in the future.

JOHN F. KENNEDY.

THE WHITE HOUSE, *July 18, 1963.*

Senator RIBICOFF. Now, have any of the economists of the Federal Reserve System talked about how to solve those problems?

Mr. MARTIN. Well, we have some papers on them and I will get to you what material we have.

Senator RIBICOFF. Well, I was just curious—so you are getting involved with it?

Mr. MARTIN. Of course we are.

Senator RIBICOFF. Yes, involved in it—the tax bill and although it is out of your field, as you say, you are getting involved and you are in a sense legally responsible as those others in the executive branch, they also have responsibility. I am just curious what you think about it in the Federal Reserve.

Mr. MARTIN. Well, we are working continually on it.
Senator RIBICOFF. Thank you very much.
Senator CARLSON. I have just one or two questions.
The CHAIRMAN. Yes.
Senator CARLSON. Mr. Martin, I appreciate very much your coming and your courtesy here and I have been particularly interested in your colloquy between the Senator from Connecticut and the Senator from Illinois.

Now, as I gather from your testimony, it is important how you use this flow of capital, you want to get this capital into investments and into plant and equipment. Now, when you get right down to it, isn't the greatest stimulant we have in this country for expansion, the profit stimulus?

Mr. MARTIN. That is correct, and you will never have any other stimulus like profit.

Senator CARLSON. Well, isn't it true that during the last few years there was sort of a belief that there was something unclean about profits and we as a nation have been somewhat critical in regard to profits, and also we have had tax legislation that has tried to limit or drastically reduce profits—but, as a matter of fact, if we really want to expand, if we want expansion we have to have an industry that is profitable?

Mr. MARTIN. That is right, Senator, and one of the encouraging things in the last year is that in some of the industries where we have been having difficulties with their profit margin, they seem to have improved in the last year, and that is one of the greatest boosters to our economy that we have.

Senator CARLSON. And we will have to go into this very thoroughly, and its effects upon our economy and the effects upon the balance of payments and this flow of funds that you were talking about—and after all, our people are good business people, and if the profits had been greater overseas, the investments would have been greater, the money that went overseas, affecting the balance of payments of this Nation, and I think that the lack of profits or the low profits—and I think that it can be proven that there have been low profits or subnormal profits which have resulted in subnormal investments in that respect which resulted in a subnormal number of jobs—and perhaps, would you agree, that it would be best to take a good close look at this thing from the profit standpoint?

Mr. MARTIN. I could not agree with you any more, Senator, and we ought to do all we can to help.

Senator CARLSON. That is all.

Thank you, sir.

Mr. MARTIN. Thank you.

The CHAIRMAN. Thank you very much, Mr. Martin, for giving your very valuable testimony. We are always glad to have you come in here.

Mr. MARTIN. Thank you.

The CHAIRMAN. This concludes the open hearings on the tax bill. We will have an executive hearing tomorrow morning.

Thank you.

I place in the record a letter from Mr. Eugene F. Rinta, executive director of the Council of State Chambers of Commerce, relative to

the testimony of Mr. John L. Connolly before the committee on October 25, 1963, in part 2, beginning at page 935.

(The letter referred to follows:)

COUNCIL OF STATE CHAMBERS OF COMMERCE,
Washington, D.C., December 6, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: You will recall that Mr. John L. Connolly, chairman of our Federal finance committee, appeared before the Senate Finance Committee on October 25 in connection with the tax bill, H.R. 8363. In addition to our views on the tax bill, Mr. Connolly expressed the concern of our constituent member State chambers of commerce for control of Federal spending at a level which would permit meaningful tax reduction now and a balanced budget at an early date. At that time Mr. Connolly recognized the difficulty of legislating a plan to control and reduce expenditures and, in our behalf, he called upon the administration and the Congress to clearly demonstrate their intent to bring spending under control.

Because of your devotion to the cause of Federal expenditure control and fiscal responsibility, I believe that you will be interested in the enclosed telegram which our committee sent to the President yesterday with respect to his efforts to get Federal spending under control. In our message to the President, we urged his administration to hold proposed Federal spending in the 1965 fiscal year down to no more than the $98 billion estimated for the current fiscal year and to submit new obligational authority requests at less than the expenditure total.

With expressions of my esteem,

Sincerely,

EUGENE F. RINTA, *Executive Director.*

[Telegram]

WASHINGTON, D.C., *December 5, 1963.*

The PRESIDENT,
The White House,
Washington, D.C.:

The Federal Finance Committee of the Council of State Chambers of Commerce, meeting in New York City, has noted with appreciation news stories citing your intentions and efforts to restrain further budget growth and that you have urged business and labor to get strongly behind the tax reduction bill pending in the Senate. Our committee agrees with you that tax reduction is urgently needed to assure greater economic growth and more jobs and we have so informed the Senate Finance Committee. At the same time, however, we believe that the economic benefits of the tax bill, including betterment of the balance-of-payments position, can be fully retained in the years ahead only if the Government's fiscal position is strengthened through strong expenditure restraint. We urgently recommend, therefore, that your administration develop a budget for the fiscal year 1965 which will not exceed the current year level of $98 billion in expenditures under the administrative budget. We further recommend, in order to assure control of spending near that level and to permit receipts to catch up with expenditures at an early date, that proposed new obligational authority in the 1965 budget be held to a level somewhat less than the expenditure total. We are convinced that these budget levels are feasible of attainment and, in fact, should be maximum bases for consideration by the Congress. We are also convinced that, if the budget you submit to the Congress in January is of the dimensions recommended here, tax reduction will be enacted early in the next session of Congress.

JOHN L. CONNOLLY, *Chairman.*

(Whereupon, at 12:40 p.m., the committee was adjourned.)

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